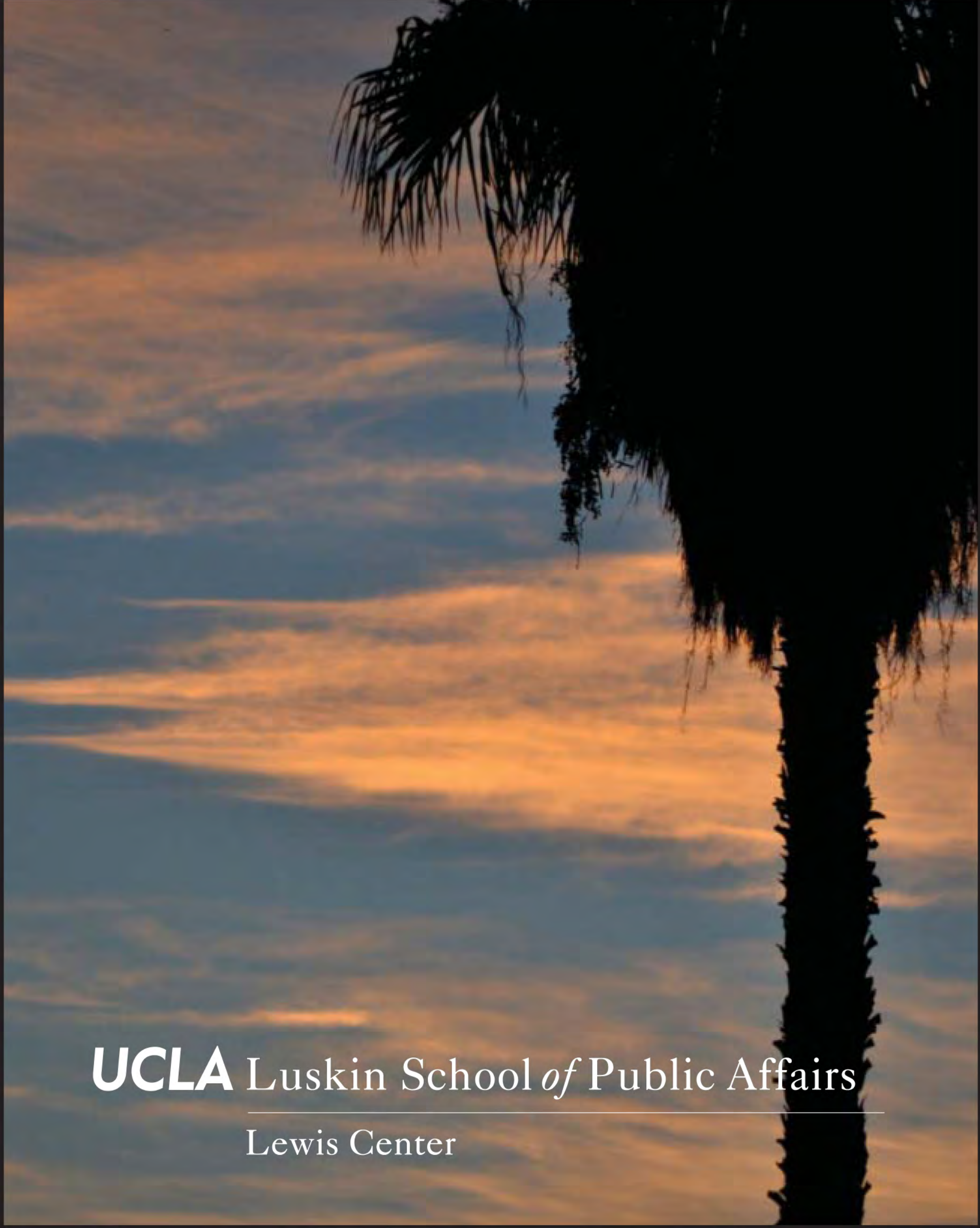

California Policy Options 2013

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Edited by Daniel J.B. Mitchell

UCLA Luskin School of Public Affairs
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Preface

California Policy Options is an annual collection of research and insight on issues and challenges facing the State produced by the UCLA Luskin School of Public Affairs and our Ralph and Goldy Lewis Center, which advances research solutions for California's urban and regional challenges, with an emphasis on transportation, economic development and housing, and the environment.

Each year, Professor Daniel J.B. Mitchell collects and edits a collection of new California-focused articles by Luskin and Lewis Center center-affiliated UCLA faculty and graduate students. The volume becomes the reader for an always lively and current undergraduate class on California policy issues taught each winter quarter by Professors Mitchell and Michael Dukakis. It is distributed to libraries and made available on School and academic websites for researchers, journalists, and citizens. Professor Mitchell also contributes a seminal analysis of the state's budget processes and details.

California Policy Options exemplifies many of the values and goals of the UCLA Luskin School of Public Affairs and the Lewis Center. It works across academic boundaries. It covers a wide range of issues. And it provides dispassionate empirical analysis from both the macro and micro view of pressing public policy problems important to us all.

Franklin D. Gilliam, Jr.

Dean
UCLA Luskin School of Public Affairs

Introduction

Our annual *California Policy Options* volume for 2013 devotes half its attention on matters relating to taxes and state fiscal policy; four of our eight chapters deal with those matters. Perhaps that emphasis is not surprising given the fiscal focus at the state level in the November 2012 general election. Three of the November ballot propositions dealt with tax increases (and two passed). One proposition dealt with the process of state budgeting (and didn't pass). Apart from our fiscal focus in this edition, we continue our past practice of highlighting student research on California policy in the Luskin School of Public Affairs. Three of our chapters are based on student research projects.

Our volume begins with a chapter on a tax credit given by the state in 2009 to encourage local film and TV production. As Lauren Appelbaum, Chris Tilly, and Juliet Huang note, other states and countries have encouraged what some call "runaway" production (production outside California) by giving various tax credits to producers. The authors find that these credits do have the effect of drawing production away from California. Runaway production could have a cumulative effect as the out-of-state locations build up local industry infrastructure and workforce skills. They also find that the benefits of the California tax credit modestly exceed its cost.

Phillip Blackman and Kirk Stark note that given California's ongoing state budget crisis, any federal dollars that can be brought in would provide some fiscal relief. They find an oddity in federal tax law related to charitable contributions and other aspects of the U.S. tax code that could attract federal dollars. Blackman and Stark do not argue that the oddity is good national public policy. But they note that since the potential exists for a benefit to the state, legislators should at least investigate this opportunity.

Jenna Chilingerian notes the growth over time in a public policy interest in California in preserving historic structures. Many such structures are in private hands, however, and private owners do not necessarily have the same interest. Nonetheless, incentives, such as reduced property tax rates, can change the calculus for such owners and have been offered in California. Chilingerian notes that California could go further in offering preservation inducements to property owners but before making such a commitment, she suggests that the state conduct a survey to determine what benefits might accrue.

In his chapter, Daniel Mitchell continues his history of California's budget story that has appeared in prior editions of *California Policy Options*. This time the history extends through the close of the legislative session in August 2012. By that point, through the initiative mechanism, the governor had placed a tax proposition (Prop 30) on the ballot, sold as a remedy for the ongoing budget crisis. His use of the initiative approach resulted from the prior year's ill-fated attempt to garner enough votes in the legislature to place a similar proposition on the ballot. We know, with hindsight not available when the chapter was written, that in fact the governor's initiative passed, a story that awaits future editions of this volume.

In many ways, California's economy depends on its infrastructure. Of course, infrastructure has direct costs related to construction. But there are also ongoing costs, including potential negative "externalities." The twin ports of Los Angeles and Long Beach are by far that largest seaport complex in the U.S. But internationally traded products that go through the ports must arrive and depart through land transportation. Both ports have developed clean trucks programs designed to reduce air pollution. Under these programs, old trucks are being removed from service and replaced by lower-polluting vehicles. In his chapter, Zachary Rehm finds that the programs of the ports, which essentially subsidize the truck replacements, have been effective in producing a significant air pollution reduction.

After the 2001 terrorist attacks on the U.S., the L.A.-Long Beach port complex was seen as possessing another negative externality: the potential attraction of such an attack on the ports, possibly using a "dirty bomb." In addition, such an attack would close the ports and halt the large volume of trade passing through them with important negative impacts on the economy. In the 2005 edition of *California Policy Options*, a chapter by Zegart, Hipp, and Jacobson found notable deficiencies in the homeland security protections that had been developed up to that point for the two ports. William Sholan, in his chapter in the current edition, investigates whether the security umbrella has improved since 2005 and finds that it has. Security cannot be 100% effective but there has been a notable increase in funding and in coordination among the various agencies responsible for port protection.

As we look ahead, the state's economy remains a major concern. California was hard hit by the Great Recession and its recovery – while steady – has not been fast enough to bring the unemployment rate down to its pre-recession level. Jordan Levine and Christopher Thornberg of Beacon Economics find that the state's recovery can be expected to continue, even if at a modest pace. The fundamentals factors underlying a recovery appear to be in place and seem unlikely to be derailed.

Finally, William Parent looks at the political outlook for California through the lens of the state's new-old governor Jerry Brown. Brown is the second governor in the state's history to be elected to three terms (after Earl Warren) and, given term limits, will be the last. He succeeded in inducing voters to enact Prop 30 in 2012 and his party now holds a two-thirds margin in the legislature. However, Brown faces challenges, even with Prop 30 in place, regarding the budget. Moreover, there are other issues facing the governor such as his goal of high-speed rail construction and other infrastructure development. Finally, Parent suggests that given the two-thirds margin of Democrats in the legislature, Brown will be facing bold proposals for tax and governance reform from his party and will have to decide his own position on such matters.

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CHAPTER 1

Economic and Production Impacts of the 2009 California Film and Television Tax Credit

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This research was funded by the Headway Project. An earlier version of this chapter appeared as a UCLA Institute for Research on Labor and Employment report, *Economic and Production Impacts of the 2009 California Film and Television Tax Credit* (Appelbaum et al., 2012), and was adapted in the Headway Project report *There's No Place Like Home: Bringing Film & Television Production Home to California* (Kong and Bette: 2012)

Hollywood remains the capital of the global entertainment industry, but in recent decades other cities and countries have attracted film and television production away from California, often using government incentives to clinch the deal.[1] In 2009, responding to job losses, California adopted the California Film and Television Tax Credit, giving tax credits to companies in return for in-state productions. In 2012, with the original legislation due to expire, there was hot debate about whether to renew it – with some arguing that it created more than enough jobs to justify its cost, whereas others termed it a boondoggle for Hollywood.

The legislation was ultimately renewed, but the controversy continues. This chapter investigates the importance and impact of the California tax credit. We examine both the immediate economic impact of the tax credit and the longer-term impacts on California's dominance in the film and television industry. The evidence suggests that film incentives do influence production location decisions. While not the only factor involved in the decision making process, productions do seem to follow the incentives.

Our analysis is based on a detailed review of the literature on production incentives, an original survey of producers in California, and re-analysis of a 2011 Los Angeles Economic Development Corporation (LAEDC) report that reported a substantial economic payoff to the credit. We conclude that the California tax credit is likely creating jobs and a small economic benefit to the state. The LAEDC report found that the tax credit returned $1.13 for every $1 of tax subsidy and concluded that the subsidy provided a net positive return to the state. However, we find a problem in the analysis of the fiscal impact of the subsidy on the state budget.

LAEDC assumes that all productions applying for a subsidy – but not receiving one – will leave the state. In order for the state to break even on the tax credit, at least 88% of productions applying for but not receiving the credit would have to film outside of California. However, data from a subsequent year show that of the productions that were produced despite applying for, but not receiving a subsidy, five out of 14 productions, accounting for 8.4% of the total production budgets, filmed in California without getting a tax credit. Thus the economic benefits associated with those five productions should not be included in calculating the return to

[1] This research was funded by the Headway Project. An earlier version of this chapter appeared as a UCLA Institute for Research on Labor and Employment report, *Economic and Production Impacts of the 2009 California Film and Television Tax Credit* (Appelbaum et al., 2012), and was adapted in the Headway Project report *There's No Place Like Home: Bringing Film & Television Production Home to California* (Kong and Bette: 2012)

the state. This reduces the fiscal impact of the tax credit such that the state may recoup as much as $1.04 per $1 of tax credit allocated, but not $1.13.

In addition, taking a longer term perspective, the California Film and Television Tax Credit is keeping productions in the state, which will serve to maintain California's dominance in the film and television industry. The industry is a significant part of California's economy. For that reason, we argue that it is important to maintain California's status as an industry leader with a qualified indigenous workforce.

In the next section we briefly review the research literature on production location decisions in order to examine the impact of incentives on these decisions. We examine the role of incentives in global competition for production as well as state-level incentives. Other factors that affect location decisions are labor costs, crew depth and quality, and infrastructure development. We review the effects of these factors as well. A second section reports the results of an original survey of California film and television producers who have applied for the California Film and Television Tax Credit. A review of research on the net economic impacts of film subsidies makes up the third section. A final section discusses net economic benefits of film and TV subsidies, and provides a critical analysis the LAEDC report on the impact of the California Film and Television Tax Credit. We then close with brief conclusions.

Location Decisions: What Does Previous Research Show?

Numerous factors influence producers' decisions about where to produce a film or television program. There is a complex relationship between incentives and the other factors contributing to production location decisions. We examine these issues here.

Film Industry Incentives

Research on production location decisions indicates that incentives have a significant impact on shifting productions away from California and in the emergence of new production locations in Canada, other countries, and other states. Other locations have chipped away at California's lead with lower costs, incentives that are easier to qualify for, and fewer regulatory obstacles to production. Yet, for any given production location decision, while incentives are a significant factor, whether they are the tipping point in determining if a production stays or

leaves depends on the full consideration of all relevant factors, such as total production costs, production requirements and preferences, and availability of location alternatives.

Global Incentives

In the global competition for film productions, Stephen Katz at the Center for Entertainment Industry Data and Research (CEIDR) concluded that financial incentive programs around the world significantly influenced the choice to film outside the U.S., but also acknowledged the relevance of other cost factors such as differences in wages and exchange rates, producers' preferences for the U.S., and artistic factors. Katz' 2006 report analyzed production location trends from 1998 to 2005 by genre: (1) feature films, (2) made-for-TV and mini-series as well as international and domestic factors, and (3) broadcast and cable TV shows.

As evidence of the impact of incentives on feature film production, Katz cited the example of Canada's introduction of subsidies in 1998 and its subsequent increase in productions at a time when labor costs and exchange rates were stable. In Canada, the development of the industry was boosted by incentives from the central government and subsequent enhancements from the provinces. In combination with savings from labor and a weaker Canadian dollar, the industry now provides services at a level competitive with New York and Los Angeles.

The link between the timing of the introduction of subsidy programs in other foreign countries and productions leaving the U.S. was not as strong as the Canadian example. Nonetheless there does appear to be a relationship, since as subsidy programs have begun, the U.S. share of films has declined as compared to those shot outside the U.S. California fared better than other U.S. states in terms of competing with foreign locations because of an on-going "competitive edge" in "talent base and infrastructure" (Katz 2006, 1-4).

In the category of "Made-for-Television Movies and Miniseries," 90% of productions stayed in the U.S. or Canada as compared to only 10% that leave North America for other countries. Katz at the Center for Entertainment Industry Data and Research attributes this result to three factors: 1) foreign production incentives do not sufficiently outweigh the added costs of going abroad; 2) the limits of other countries' capacity in terms of production staff and infrastructure; and 3) the ability to obtain competitive labor costs from unions or to use non-union labor on smaller budget productions in both the U.S. and Canada.

Between the U.S. and Canada, the choice evened out to slightly favor the U.S. because of U.S. legislation enacted in 2004 benefiting television production (Katz 2006, 5-6). "Broadcast and Cable Television Productions," a category including scripted and reality programs, were less likely to leave the country than films. This reluctance to leave occurs is because a television series might film nine months out of each year for several years, rather than filming for a relatively short three-month stint abroad. The longer outlook may create complications in "relocat[ing] the necessary American talent" (Katz 2006, 6).

State-Level Incentives

Within the U.S., production location decisions are also affected by the differing incentives offered in competing states. In reviewing the reports available on state programs, researcher Darcy Rollins Saas at the Federal Reserve Bank of Boston found in 2006 that film tax credit programs successfully lured productions to some states. But some credits were given to productions that would have filmed in-state anyway.

In 2010, Robert Tannenwald, writing for the Center on Budget and Policy Priorities in Washington, DC, stated that film production incentive programs may have succeeded in attracting productions because of high levels of subsidization. For example, Louisiana increased from one film produced in 2002 to 54 films produced in 2007. Prior to Louisiana's 2002 enactment of tax credits, the state's annual film production ranged from $10 million to $30 million and was sporadic. After enactment, it increased to $354.7 million in 2004. Rhode Island, Massachusetts, and New Mexico also experienced large increases in film production spending after enacting tax credits (Economic Research Associates 2009; Saas 2006; Tannenwald 2010). However, as noted in Saas (2006), most of the credits in New York went to existing, not new, productions.

Recently, New York conducted a natural experiment demonstrating the potential impact of incentives. According to the New York State Department of Taxation and Finance (2010), although approved through 2013, New York State's production tax credit program ran out of money in 2009. By the end of 2009, additional money had been allocated for the program. However, during the time that New York had no ability to allocate tax credits to new productions, there was a dramatic decline in the filming of television pilots. In the spring of 2008, 20 television pilots filmed in New York. However in 2009, only four pilots were able to

apply for the tax credit before the funds ran out. *Los Angeles Times* reporter, Matea Gold, and *The Observer* reporter, Joanna Walters, indicated that no other pilots were shot in New York during the spring of 2009.

In 2010, when there was again money available for tax credits, many new and returning pilots shot in the state. In the 2010-2011 television season, 22 TV pilots were filmed in New York City (Gold 2009; New York State Department of Taxation and Finance 2010; Walters 2011). Some pilots may have waited and shot a year later in 2010, but it is likely that in 2009 many of the pilots that would have filmed in New York went to a different state with an incentive. Supporting this possibility is research by Canadian researchers, Charles Davis and Janice Kaye (2010), which highlights concerns about retaliation against locations that withdraw their production incentives.

In 2007, researchers Isaiah Litvak and Marilyn Litvak noted that the "project-based" nature of film and television productions allows them to easily pick up and leave in order to take advantage of cost differences in different locations. However, incentives are not the only deciding factor, rather total cost and production requirements taken together must be favorable for a production to move location.

Total production costs consist of above- and below-the-line costs, exchange rates, residuals, and government incentives or lack thereof. Production requirements include "infrastructure, crew depth and quality, and locations that are appropriate and accessible" (Litvak and Litvak 2007, 8). Artistic, creative, and director or actors' preferences are secondary and are only taken into consideration while making the final decision about location (Litvak and Litvak 2006; 2007).

To support their argument, Litvak and Litvak (2007) analyze the decision factors in two case studies: *Cold Mountain* and *Walk the Line.* North Carolina lobbied producers hard for *Cold Mountain*, but lost out to Romania. A key factor was the producer/director's preference for high above-the-line spending to pay for top actors on an $83 million budget (as compared to MPAA estimate of an average studio budget of $60 million with around one-third spent on location), putting pressure to save on below-the-line costs. The film saved on labor that was a fraction of the U.S. labor cost and benefited from then-prevailing exchange rates.

Tennessee persuaded *Walk the Line*, a $28 million budget film, to film in its state rather than save $3 million by filming in Louisiana, primarily by giving "soft incentives" (free

space/use of government buildings, local hotel/motel tax refunds, and use of a state plane). In addition, actress Reese Witherspoon's influence on the studio played a role in the decision. In this second example, soft incentives were as important as incentives created through tax credits.

While incentives have the potential to create a competitive edge, their full impact remains unclear. For instance, the research brief for the California Legislature written in March 2011 by Brian Sala and Maeve Roche of the California Research Bureau did not find a clear impact of the proliferation of incentive programs in other states on California. Their presentation of FilmL.A. data on permit production days in the Los Angeles area reported declines in film production. This trend may have been an indicator of possible relocation of productions, but U.S. government data on employment (in the broader category of film and video production) and a summary of studies on state programs, provided by Sala and Roche, did not suggest a trend of job loss over the last decade.

Anecdotal evidence suggests that some films that could have been produced in California left and were produced in other states. However, the largest growth in production related jobs in other states seems to have occurred immediately following the passage of incentive programs. For the most part, the number of production jobs in other states has held steady or declined since the years immediately after these programs were implemented.

Thus, there may be a trend of film productions being made elsewhere, but this trend is more likely reflecting flight to locales outside the U.S. such as Canada (with well-established incentives) and Romania (with low labor costs). These findings are similar to a 2005 report to the legislature produced by the California Employment Development Department which also found it difficult to attribute employment trends to a particular source: "Because film production location studies differ on how much film activity is occurring outside California, it is less clear whether falling employment is due to 'runaway production' or to other factors" (Employment Development Department 2005, vii).

Wright et al. (2009) examine the impact of New York's refundable credits, which were enacted in 2004, during the period from 2003, one year before enactment, through 2006, two years after the incentives were enacted. Wright et al. reported that the impacts of New York's incentives during this period are mixed in terms of Census data on employment, payroll, and number of businesses with "modest growth." In the same period, California with no incentive program showed "some growth" in payroll and employment. However, Wright and co-authors

also found that states that have little or no film industry prior to enacting motion picture tax credits are successful in luring projects. They argue that the permanence of these effects is still uncertain and states using incentives to create a new film industry may not stimulate enough economic activity to pay for the loss in tax revenue resulting from the incentives. However, for locales where the industry is established such as, California, New York, and Vancouver, incentives may help to sustain comparative advantage.

The vast majority of states have some form of a film incentive program, including tax credits, rebates, and exemptions. According to Sala and Roche (2011), the number of states offering a production incentive (although not necessarily a tax credit) increased from five in 2002 to a high of 44 in 2010. However, organizations tracking state programs differ in their counts of states. In a report written for the Tax Foundation in 2010, Will Luther stated that 44 states had an incentive program in 2009 and Tannenwald (2010) found that 43 states had such programs in 2010. In January 2011, the National Conference of State Legislatures (NCSL) reported that 45 states and Puerto Rico offered incentives.

Recent state budget and economic problems have caused lawmakers to question the value or the size of film tax incentives. States such as Michigan have been severely cutting back on public services in the face of major budgetary distress. In Wisconsin, a state report showing a lack of positive returns on the film incentive prompted the governor to reduce the program. In fact, challenges to state programs occurred in nine states, while eight states renewed or increased programs. Henchman at the Tax Foundation has tracked the number and value of film and television tax incentives by year since 1999. He found a recent peak in 2010 of 40 states offering a total of $1.4 billion in incentives and a subsequent scale back that will result in 35 states having incentive programs as of 2012 (Henchman 2011).

Labor Costs

While incentives do play a role in production location decisions, other factors must also be considered. Researchers Allen Scott and Naomi Pope (2007) argued that the global nature of production may relegate the impact of state film tax incentives to being temporary and marginal, as has occurred in other industries. Filming as an outsourced activity appears to be following the path of manufacturing. The savings from locations outside of North America may be at levels incentives cannot match. Labor may be 25-35% cheaper than the U.S. New facilities with lower

costs are also adding to the appeal of locations such as Eastern Europe, New Zealand, and Australia. Labor, studio space, and subsidies all add up to favorable conditions abroad (Scott and Pope 2007).

Researcher Adrian McDonald (2007) acknowledged the cheaper labor costs in countries such as in eastern European countries like Romania. He cited the large overall increase in production spending (927%) across Eastern Europe between 2001 and 2005. As long as labor costs remain low in poorer countries, industrialized nations like the U.S. and Canada will have a difficult time competing for productions, even with generous tax incentives. Nonetheless, citing the increase of production in Canada during a time when there was no significant change in the exchange rate, McDonald concludes that within the developed world, government incentives are the main driver of economic runaways.

Within the U.S., government employment data do indicate significant labor cost differences among the states. While union contracts may call for uniform benefit levels throughout the country, workers in one location may earn significantly more or less than workers in another (Bureau of Labor Statistics, 2011). However, the potential labor savings from low-wage states are mitigated by the lack of available, skilled production crews, resulting in the importing of labor from other states. Some of this imported labor undoubtedly comes from California, creating a lack of clarity of the trends in California film and television industry employment.

Crew Depth and Quality

A salient dimension of labor affecting film location seems to be crew depth and quality. Staffing capacity limits decisions on where a production can go. Researchers Susan Christopherson and Ned Rightor (2010) describe this as a paradox created by the problem of availability of specialized professional and technical skills. “A state has to get multiple projects to keep skilled crew employed consistently (so that they won’t leave for greener pastures or take a job outside the industry), but it also has to have enough skilled crew *unemployed* and available so that they can attract new productions.” (Christopherson and Rightor 2010, 4).

Anecdotal information from industry professionals supports the view that this paradox impacts production location decisions. In describing some recent choices for film locations, Greg Marcks, a director and screenwriter, noted that in 2002, he had considered New Mexico for the

incentives, which required local hires to qualify. But he ended up filming in Los Angeles because the entire local crew base was already employed on other projects (Marcks 2007).

Infrastructure Development

One effect of productions moving out of California is the potential development of infrastructure in other locales. Outsourcing to Canada provides an example of both the possibility of gradual development of an industry cluster and the challenges. Davis and Kaye (2010) argue that service providers in Canada have benefited from outsourcing to Canada. They draw a distinction, however, between service provision sustained by subsidization with tax credits and independent firms that can become self-sustaining with profits from the ownership and licensing of intellectual property.

When not restricted by firm origin, tax incentive programs may attract foreign productions and create work for service providers. Canada has been very successful with developing service provision, but has had more modest results in developing "business and creative" capabilities. While subsidies supporting firms that serve foreign production companies have provided opportunities for developing skills and creating steady revenues, they have potential drawbacks. These drawbacks include spending on foreign productions that could have gone to developing Canadian firms, becoming relegated to lower rungs of service providers to Hollywood, and escalation of the competition to be the lowest cost location.

Nonetheless, Canada has been quite successful in creating an industry cluster. In the 1970s, the British Columbian government initiated efforts to attract Hollywood productions to replace productions the national government had moved to Ontario and Quebec. This program built a base of service providers and independent production firms.

Outsourcing increased rapidly with the introduction of Canadian incentives in the late 1990s. Canada offered foreign productions lower labor costs, accommodating labor unions, proximity to Southern California, good weather, and range of scenery. For Canada, the industry has attracted work for service providers whose employees have gradually moved up to more skilled production work and provided financial resources for some firms to stay in business long enough to develop higher-order creative and business capabilities. Despite the growth of the film and television industry in Canada, Davis and Kaye assert that strategies such as international

partnerships rather than service provision would be even more effective in developing the industry (Davis and Kaye 2010).

The literature on relocation within the U.S. reaches varying conclusions on the current state of cluster development outside of Southern California and New York. Some observers argue that the infrastructure has already developed in states such as Louisiana or New Mexico, while others point to the enduring dominance of the two leaders. Klowden, Chatterjee, and Hynek's 2010 report for the Milken Institute focused on the impact of incentives on the decline in film production and what they characterize as a drop in movie and video industry employment between 1997 and 2008.[2] The authors attributed these declines to increasing competition from Canada and some U.S. states that already have incentives, a qualified workforce, low costs, and a developed infrastructure.

Infrastructure development also extends to post-production where technology enables the work to be done outside the U.S. or in other states at lower costs than in California. Thus, many states have "built a true critical mass of production and post-production activity that can sustain ongoing work rather than just landing one-shot individual projects" (Klowden, Chatterjee, and Hynek 2010, 4). For instance, as indicated in a 2010 report published by the Los Angeles Economic Development Corporation, infrastructure development in Michigan, Louisiana, and New Mexico, has included construction of studios, sound stages, and post-production facilities (Kyser, Sidhu, Ritter, and Guerra 2010).

The 2010 LAEDC report argued that California's unique confluence of well-regarded film schools, the entertainment "community," production crew depth and quality, technological expertise, multiple suppliers, and jobs when not working in entertainment would be difficult to imitate. Nonetheless, the Los Angeles-Orange County area saw a decrease in its share of industry gross product from a 2004 high of 57.7% to 53.9% in 2007. The enactment of the film tax incentive and inventory stock-piling before the 2011 union contract expirations were expected by LAEDC to lift 2010 production levels. However, LAEDC advised maintaining the tax credit program and "monitor[ing] the results of California's film incentive program to see if it needs to be enhanced" (Kyser et al. 2010, 12) as well as watching trends in post-production.

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[2] It should be noted, however, that there was a spike in employment beginning in 1995 and continuing through 1997, followed by a drop in employment in 1998. This drop occurred before most state incentive programs were implemented, although it does follow the implementation of Canadian film incentives. Industry employment levels did increase again between 2002 and 2008, although not quite reaching the peak employment level found in 1997.

According to Scott and Pope (2007), Hollywood's sustained competitive advantage in the entertainment industry endures because of a unique mix of advantages of concentration, artistic talent, distribution, and marketing. Some pieces of production, such as filming, began to drift away from Hollywood as early as the 1950s and this trend has increased in recent decades. The causes are both creative and economic. The economic runaways result from relative differences in labor costs, the self-contained nature of filming tasks, and financial incentives. Possible destinations may be constrained by quality and quantity of facilities and workers. As compared to pre- and post-production, film shoots are less enmeshed in the rest of the production system and can be separated for outsourcing elsewhere. While the shift has been significant and will likely continue, film shooting activity is one piece of a larger production and distribution system deeply embedded in Southern California.

Scott and Pope (2007) therefore conclude that there "is thus far little or no evidence to denote that a wholesale rout is in the offing" (Scott and Pope 2007, 1372). Scott and Pope contend that small-scale productions will be difficult to move because there is insufficient scale to recoup the fixed setup costs. Complex productions will be difficult to move because of the costs of bringing in specialized workers and the transaction costs of more intense control and coordination needed with the head office in Hollywood. Nevertheless, over time, the "satellite production center" might improve its capacity for handling more complex projects. Simple, repetitive filming such as some television series would, however, be easier to move (Scott and Pope 2007).

States have difficulty building long-term industry clusters. Despite offering incentives for many years, they are still competing with subsidies. Through training programs in New Mexico universities and construction of studios in Louisiana, the two states have worked toward building clusters. Although this step resolves some capacity issues, the new locations require continued subsidies because productions are still temporary, mobile, and not self-sufficient (Tannenwald 2010).

<u>Long-Term Sustainability of Incentives</u>

Despite the ability of incentives to attract film and television production, some authors raised concerns about the sustainability of incentives and their impact on long term economic development. Litvak and Litvak (2006) asserted that these "artificially created competitive

advantages through select government incentives and related subsides are not sustainable" (Litvak and Litvak 2006, 281) and it is doubtful that they will lead to clusters of film and television production activity on scale with the "Los Angeles-Hollywood colossus." They expressed concerns over high costs of the tax breaks and forgone alternatives resulting from the escalating competition for projects.

Litvak and Litvak argued that incentives may sway the location decisions of film productions at the margin once other production needs are met. But the prize is a temporary "floating factory," while alternatives such as investments in improving workers' skills or creating other business that will stay for more than a few months may yield better long-term results. The authors also question whether government officials are able to make good deals and strike the right balance in their level of spending to attract temporary enterprises.

Researchers Kathleen Wright, Stewart Karlinsky, and Kim Tarantino (2009) argued that there is a downward economic spiral when states compete against each other and end up spending more than necessary. The authors indicated that there are several other shortcomings of tax incentives. These deficiencies include the subsidization of existing in-state businesses unrelated to film when transferable credits are sold, income and income taxes that go back home when non-resident staff and businesses leave, cash rebates as incentives that are not required to be spent in state, and the waste of spending incentives on productions that were already going to film in-state.

Sala and Roche's (2011) analysis of other academic and state government studies of incentive programs in a variety of states demonstrated that in many states other than California, non-residents received most of the jobs created. Sala and Roche's analysis indicated that many of these out-of-state employees may have been from California. Also coming to this same conclusion are a number of other reports, coming from a variety of institutions (e.g., Joseph Henchman [2011] and Will Luther [2010], both of the Tax Foundation, Robert Tannenwald [2009], writing for the Center on Budget and Policy Priorities, and Jennifer Weiner [2009] a researcher at the New England Public Policy Center of the Federal Reserve Bank of Boston). For example, as noted by Navjeet Bal of the Massachusetts Department of Revenue, in Massachusetts in 2009, only 33% of spending on eligible expenses from productions was paid to Massachusetts residents or Massachusetts-based businesses. Similarly, only 22% of new production related wages and salaries were paid to Massachusetts residents in 2011 (Bal 2011).

Summing up the Evidence on Incentives' Effects

It is clear that incentives have a significant impact on production location decisions. In particular, Canada has fared well since the introduction of film industry incentives in 1998. Furthermore, the vast majority of U.S. states have some sort of film incentive program. Labor costs differences can affect location decisions. However, labor costs advantages may be offset by a lack of crew depth and quality. On the other hand, film industry infrastructure may develop as production shifts to other locales. This incentive driven effect has been seen in Canada. While the sustainability of incentives has been questioned, the potential development of infrastructure in other locales can threaten California's long-term comparative advantage.

What Do the Producers Say?

The literature indicates that incentives, labor costs, and infrastructure are likely to all contribute to the production location decision. However, to understand better how these decisions are made, we surveyed a group of producers who have filmed inside and outside of California. In this way, we are able to go beyond the current literature and get a first-hand account of the factors that producers think about when deciding where to make a film or television show.

Method

We analyzed the results of an original survey of film and television producers in order to understand how they make decisions about production location. All of the producers in the sample had applied for, but not necessarily received, the California Film and Television Tax Credit at some point since the program began. Emails were sent to 111 valid email addresses. Of these 38 producers completed an on-line survey, a 34% response rate. Thus, while the response rate was excellent for a survey, the sample is small. The sample is also comprised of producers who are interested in incentives or tax credits, as they have applied for the California tax credit at least once.[3]

[3] The survey is not intended to be scientific. Rather, it is intended to allow us to understand production location decisions of producers who might produce films or television shows eligible for the California Film and Television Tax Credit. As such, the sample is appropriate to shed light on these how these decisions are made.

Production Characteristics

Overall, the median number of films produced by each producer in the three fiscal years July 1 2008 – June 30, 2011 was three. It should be noted though, that the number of productions ranged from zero to more than 75. The median typical budget for these productions was $3.75 million. Again, the range was much more diverse, with budgets starting as low as $250,000 and going as high as $75 million. The median number of films produced in California in this period was two and the mean was 5.2. The median number produced outside of California was three, with a mean of 6.6. If the one producer that made more than seventy productions outside of California is removed, then the mean number of productions outside of California drops to 3.7, noticeably less than the average number produced in California. The median number of productions made outside of California does not change and remains slightly higher than the median number of in-state productions.

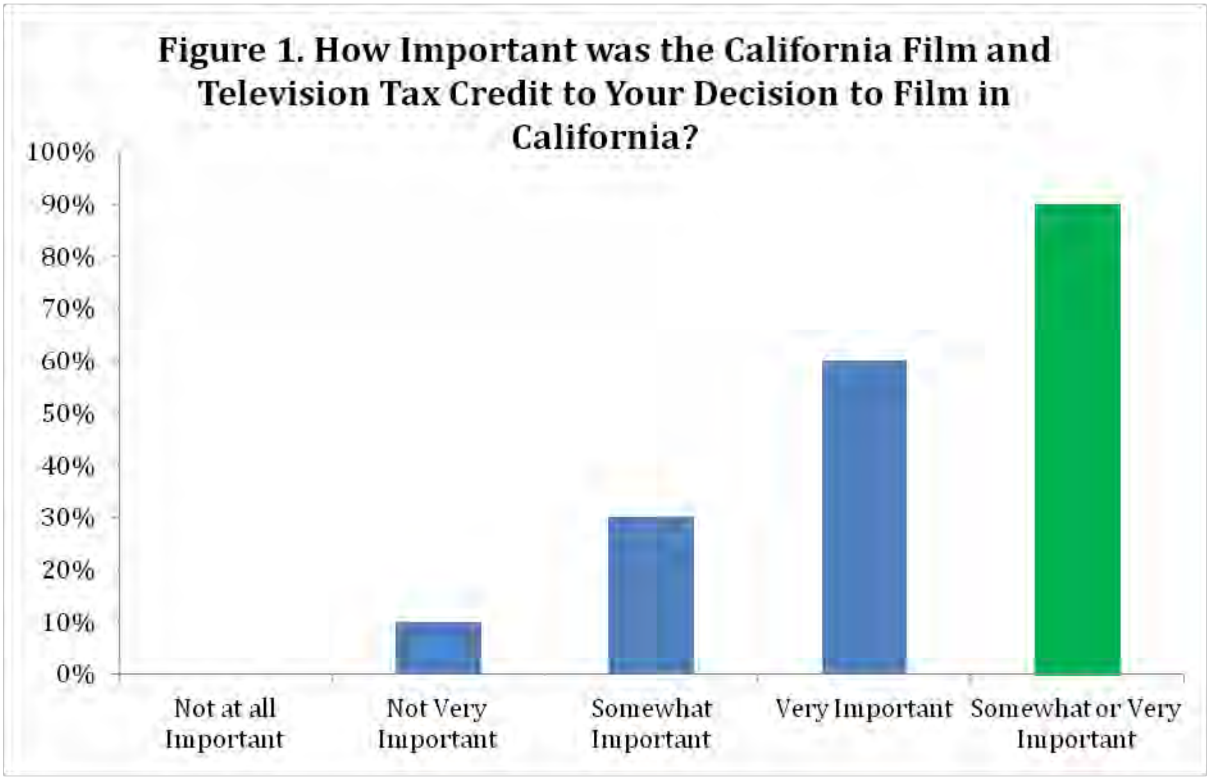
Importance of Tax Credits

All of the respondents had applied for the California tax credit at some point since the credit program began. Yet, one-quarter of the respondents who answered the question whether they had applied for the California tax credit for their most recent in-state production said that they had not done so.[4] Although they had produced in California in the last three years, they had not applied for the tax credit for their most recent in-state production. Furthermore, only two-thirds of those that did apply for the California tax credit for their most recent in-state production indicated that they had received it. Yet, all of these applicants, including the one-third that did not receive the tax credit, still produced in California. Similarly, while just over 81% of respondents said that not getting the California tax credit influenced their decision to film out of state somewhat or to a great extent, almost 19% indicated that not receiving a tax credit in California did not have any impact on their decision to film in another state.

These responses demonstrate not surprisingly that some producers are willing to make films and television shows in California without a tax credit. The credit was nevertheless an

[4] While 38 producers completed the survey, not all producers were eligible to answer every question (e.g., only people who have made a production outside of California may answer the questions about filming out of state). In addition, some respondents chose not to answer some of the questions. Therefore, when we talk about percentages of respondents answering in a particular way, we are always referring to the subsample of respondents who answered each question.

important decision making factor. Ninety percent of respondents who received a credit felt that the credit was somewhat or very important to their decision to film in California.

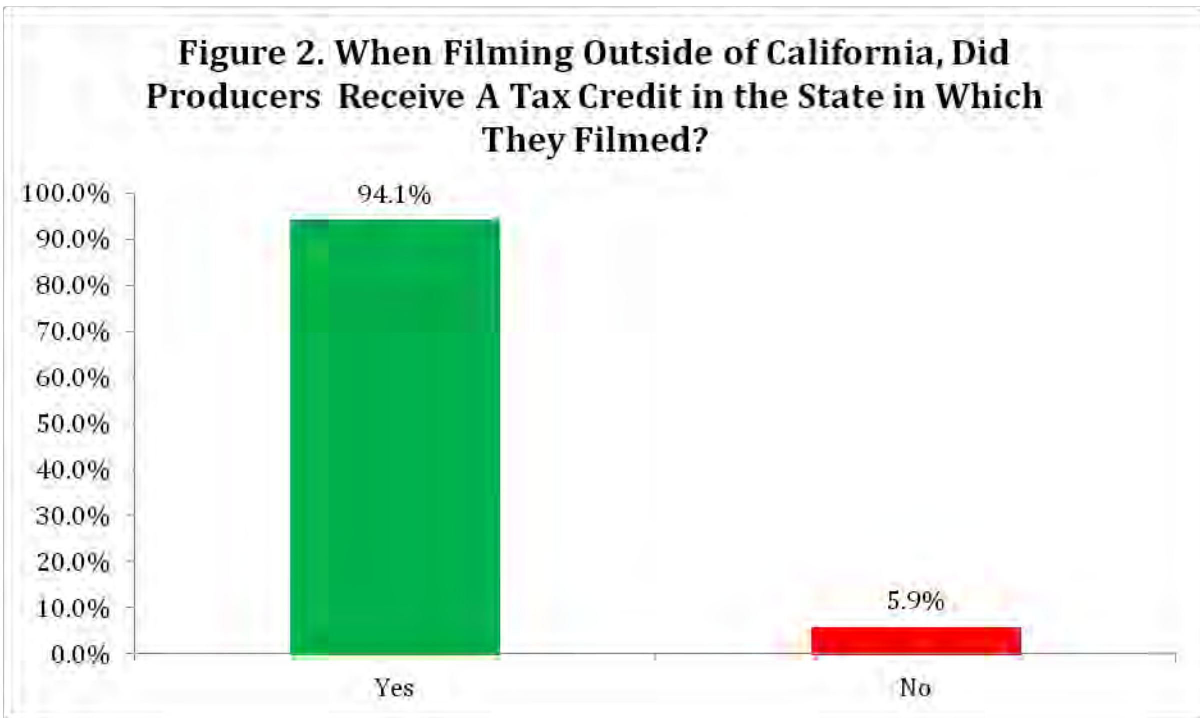


Of the three respondents who only filmed out of state, two indicated that they did not receive the California tax credit (one did not respond). In addition, when asked about the most important factors in choosing to film outside of California, a tax incentive in another state was mentioned more frequently than any other reason.[5] Furthermore, all respondents indicated that a tax credit was at least somewhat important in their decision to film in a state other than California. Getting a tax credit was very important to 86.7% of producers who filmed out of state. Even more striking was the finding that 94% of respondents filming out of state indicated that they had received a tax credit in the state in which they filmed.

[5] It should be noted however, that budget/cost, availability of qualified crew, and script location were also mentioned several times.

Table 1. Most Important Factors in the Decision to Film Outside of California

Factor	Number of Times Mentioned
Tax incentive in another state	12
Budget/Cost	7
Availability of Qualified Crew	5
Script Location/Look	5
Ease of Filming	2
Producer & Director Requests	1



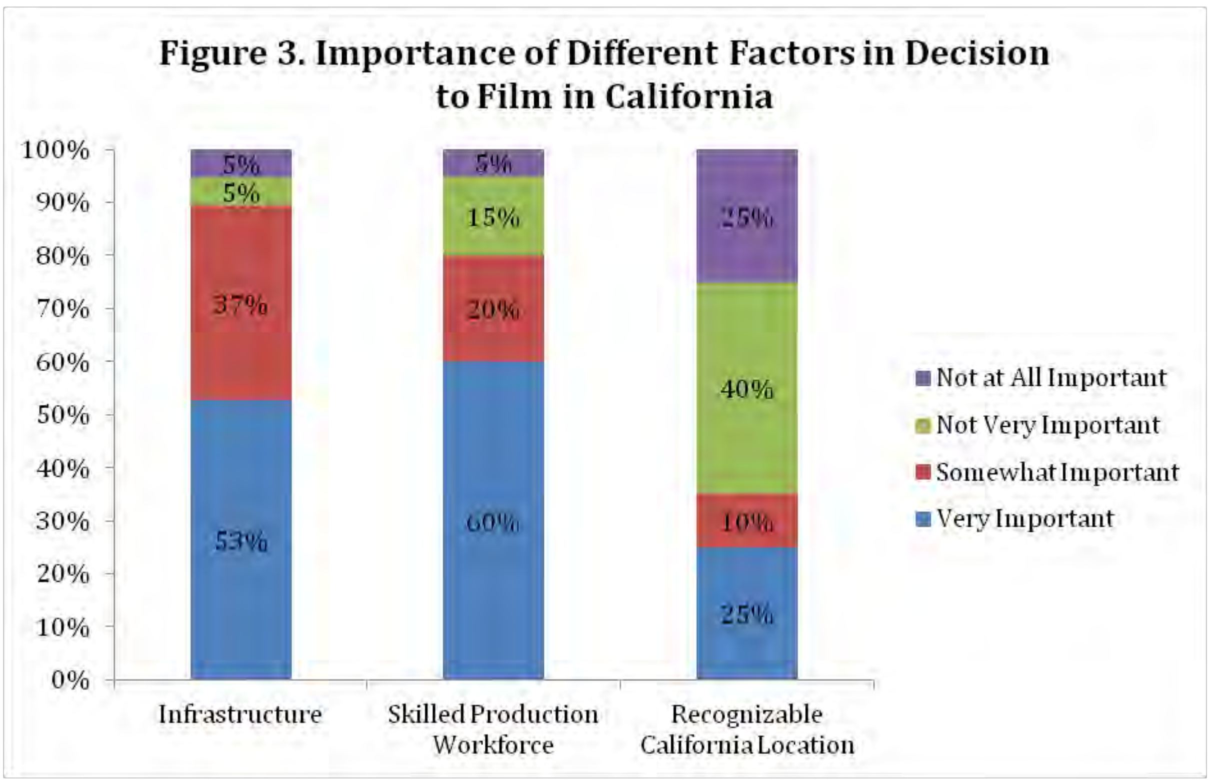
Application Process

Given that tax credits are an important part of the decision making process for producers deciding where to film, it follows that a smooth and simple application process should encourage producers to apply and stay in-state. However, the process in California poses some stumbling blocks. Nearly half (47.8%) of respondents indicated that the June 1 application deadline had stopped them from applying for the California tax credit on at least one occasion since the

program started June 1 2009. Of those that did not apply, only 40% applied for a credit for the same project in a later year. Furthermore, nearly one-quarter of respondents who received a tax credit allocation letter had difficulties using their credit. Reasons included not being able to monetize the credit, the fact that the credit was not transferable,[6] and the slow response time before being approved.[7]

Infrastructure, Workforce, & Location

There are other factors that contribute to the production location decision making process in addition to tax credits. More than half of respondents thought that infrastructure was very important to their decision to film in California and about 90% thought it was at least somewhat important. Similarly, 80% of respondents thought that a skilled workforce was somewhat or very important to their decision to film in California.



[6] The tax credit is transferable only for independent films with budgets under $10 million.
[7] Presumably, this respondent was on the waiting list and did not receive the tax credit until other productions had dropped out of the program.

While contributing to the decision making process somewhat, a recognizable California location did not influence the final location decision nearly as much as the other factors. Only 25% of respondents thought a recognizable California location was very important to their decision to film in California and 65% felt it was either not very or not at all important to their production location decision.

Survey Conclusion

While this was a small and admittedly not disinterested sample, data were collected from individuals who would be most likely to be affected by the continuance or discontinuance of the California Film and Television Tax Credit. Producers indicated that, indeed, tax credits are an important part of their film location decision making process whether the decision is made to film inside of California or outside of the state. Strikingly, 94% of producers who went out of state, filmed in a state that provided them with a tax credit. On the other hand, 25% of producers indicated that they made films in California without receiving a tax credit.

Clearly there were factors other than tax credits that were included in the decision about where to film. The most important of these were infrastructure and a skilled production workforce. Tax credits play an important part in determining whether a producer will stay in or leave a state. However, they are not the only factor that plays a role, even among producers who have demonstrated their interest in tax incentives by applying for the California tax credit at some point since it was originally authorized. Producers also described several issues that made the credit program difficult to use. These barriers included the lack of transferability of the credit, difficulties in monetizing the credit, completing production before getting a response on the application, and being disqualified for the credit because of the way people working on the production were classified.

Do Film Subsidies Yield a Net Benefit?

While not the only decision-making factor, tax incentives clearly play a large role in producers' determination of production location. Productions are likely to go where there are incentives. Given the importance of these programs for bringing filming to a locale and their widespread use, it is important to understand whether film subsidies and tax incentives are economically advantageous. The following sections of this report will look to the literature to

answer this question. We also take a close examination of the recent report of the Los Angeles Economic Development Corporation, which finds a positive financial impact for California of the California Film and Television Tax Credit.

Effectiveness of State programs

Saas (2006) suggested a policy analysis framework of evaluating tax incentives[8] against (1) their effectiveness as compared to other options for economic development such as spending on education, infrastructure, other industries or tax cuts, and (2) the impact of increased taxes or spending cuts required when tax credits do not pay for themselves. Effectiveness entails quantifying how many jobs were created and at what cost for both the tax credit program and for possible policy alternatives. On the cost side, the difficulty is in ensuring that government funds reach the target of in-state film production activities, do not pay for activities that would have occurred anyway, and do not over-pay to attract production. In practice, these goals are often not achieved and "tax windfalls" result. Saas concluded that the New England states spent credits on productions that already existed before the credit enactments and were eligible for newly created credits regardless of whether they increased production. He found that tax windfalls also could have resulted from unused credits being sold and the proceeds being spent out-of-state (Saas 2006).

Jobs Created

Counting jobs created is also complicated because the measure of interest is the hypothetical marginal increase over the level of employment that would occur without incentives. Many other employment effects such as the multiplier and the impacts of marketing and tourism are also hard to measure. Some jobs counted may have gone to job-switchers or new hires brought in from other states. It is also difficult to figure out if the temporary project-based jobs are going to the same person who eventually picks up enough work to approximate full-time work or if different people are working short stints (Saas 2006).

[8] Before discussing the efficacy of different state incentive programs, it is important to note that states vary considerably in their infrastructure, crew depth, and specifics of their tax incentive programs. California in particular has a relatively small and restrictive program, offering between 20 and 25% rebates for below-the-line expenses on projects produced at least 75% in the state. Furthermore, unlike most other states, the credit in California is not transferable. These factors increase the likelihood that California will see a positive impact from its program relative to other states with more generous and unrestrictive incentive programs since its credit is less likely to be wasted.

As for job creation and fiscal impact, Saas (2006) noted that Louisiana reported 3,000 film industry jobs created between 2002 and 2011 at a cost of $16,000 each. Outside the industry, two jobs were created for every five film jobs. The return on tax credit spending was 15 to 20 cents in tax revenues per dollar spent. In general, Saas concludes that film tax credits are not self-supporting through the generation of additional tax revenues from direct or indirect activities. However, in states with established film industries, such as New York, the evidence was inconclusive.

Lost Revenue

In light of these findings, Saas (2006) suggests that states have been giving up a lot of revenue, spending on unintended activities, and over-paying. Even if successful in reaching the goal of targeting local film production that would not have otherwise occurred, the benefits are rather modest. Indeed, many states have incurred losses on film tax credit programs, spending more on the credits than what came back in the form of new tax revenue. Luther's 2010 report for The Tax Foundation criticized the use of film tax credits for their shortcomings in delivering on jobs and tax revenues. The popularity of subsidies, they assert, is often based on flawed advocacy research for the subsidies that present exaggerated claims of benefits and assumptions. One example was a Pennsylvania report that attributed the existence of any businesses serving the film industry to the credit.

Christopherson and Rightor (2010) reach a similar conclusion on the expenses of attracting productions with subsidies that cost more than they return directly and indirectly in tax revenues. They suggest that states consider whether they really have what it takes to build a long-term future in the film/TV sector. Entertainment is strongest in California, followed by New York, while other states have comparative advantages in other types of commercial, educational, or industrial work that may offer a steadier flow than film.

Opting out of the competition may be a better option for most states. For many states, the funds could be directed towards improving skills of the workforce or towards other industries with better chances in the state for long-term success in economic development. It is possible, however, that for states with well-established and strong film and television industries, incentives could work as intended to maintain the competitive edge.

Other Reviews

Tannenwald's 2010 review of past studies on state programs for the Center on Budget and Policy Priorities draws conclusions similar to those of the Tax Foundation (Luther 2010) on job creation, tax revenues, and the escalating state competition. State programs tend to be overly generous with a median offer of 25% of qualified expenses and the upper end at 44%, and may go toward productions that would have occurred without subsidization. In fact, only one state, Massachusetts, incorporated a method to address the issue of productions that would have been produced in Massachusetts without the incentive. However, it may not be possible to distinguish such intentions from those of producers who would truly leave or choose another state without a subsidy.

New York was found to have positive returns – $1.90 in tax receipts for $1 of tax credit allocated. However, no other state studied fared this well and even the magnitude of this finding for New York is suspect. (See below for more discussion of the New York study). New Mexico state and local governments collected $1.50 per $1 spent (or $0.94 in state revenues alone) according to one study, but only $0.14 in state revenue in another study. The other states' reports reviewed by Tannenwald created less than $0.28 per dollar spent. When tax breaks do not pay for themselves, budget cuts to state programs or tax increases are needed to offset the cost and meet balanced budget requirements. Less than half of the studies reviewed account for these impacts (Tannenwald 2010).

Luther (2010) argued that in most states jobs for residents created by tax incentives are temporary, unsustainable without continued subsidization, and lack advancement potential. Tannenwald (2010) also notes the poor job quality for in-state residents in most states, who lack the skills of the workers that must be brought in from California or New York. Luther concurred that the more specialized jobs are filled by out-of-state residents. Furthermore, job counts might be overstated by not accounting for job switching by people who were already employed. Some states supported creation of film incentives based on the supposed success of Louisiana. But these states overlooked reports of poor economic results in Louisiana and the increased intensity in the competition over time that make it more difficult for late entrants to the subsidy game to catch up.

Luther (2010) provided an economic multiplier of 1.92 for film production and states that other industries have higher multipliers (e.g., Luther states that automotive manufacturing has a

multiplier of 2.25). Thus, he argues that states might do better with investing in other industries or cutting taxes more broadly. Much like Luther, Tannenwald (2010) concludes that states should scale back on incentives so they can put the funds to better use on long-term economic development such as education, infrastructure, and a neutral tax system.

While positive impacts on tourism might be possible, proponents frequently fail to provide evidence of it and fail to estimate the cost to achieve increased tourism. In addition, incentives often do not break even in terms of tax revenues because states often exempt productions from sales and use taxes. As states compete with each other, the cost of attracting projects increases and the likelihood of coming out ahead with positive returns falls. Luther (2010) further argues that California's entrance into the subsidy competition further raises the bar for other states. California's 20% or 25% tax credit and its advantage in infrastructure is likely to make it difficult for other states to provide a competitive incentive reasonably in the near future (Luther 2010).

Case Study – New York

New York and California are both different from other states in that they have a history of dominance in the film and television industry. Along with this dominance comes a fully formed industry infrastructure, with state residents who are highly qualified and available to work, state-of-the art production facilities, and strong post-production capabilities. Thus, comparison with New York is particularly instructive for California.

Ernst & Young's (2009) report for the New York film office analyzed the effect of the 2008 increase in the state's film tax credit. In response to a $750 million decline in production during fiscal year 2006-2007 (July 2006-June 2007), the state enacted an increase in its tax credit from 10% to 30% of qualified expenses. Ernst & Young estimated the impact on jobs and tax revenues by modeling the cost of the 30% credit rate and the 2007 level of film spending of $940 million. They found $1.90 returned in state and local taxes per dollar spent on credits, and $1.10 on state taxes alone. These figures exclude tourism related to film production, but include non-qualifying production activities and post-production. For the remainder of 2008 after enactment of the increase in credit rate, applications totaled 100, an increase from the 60 received in the same period of time in 2007.

The Ernst & Young (2009) model estimated that 19,512 jobs would be created or retained. This figure consists of 7,031 jobs created from direct spending on the productions eligible for the credit and 12,481 jobs from indirect spending. The firm asserts that this is an increase over previous years and a reversal of the loss in New York's share of U.S. film industry employment from 13% in 1999 to 8% in 2004. They state that if "employment had continued to decline through 2006, New York employment in the industry would have been 9,472 in 2006—6,115 fewer jobs than the 15,587 actual jobs in 2006 under the credit program"(Ernst & Young 2009, 7).

Even though New York may be more likely than many other states to reap a positive benefit from its production tax credit, there has been criticism of the Ernst & Young report. Weiner (2009) critiques the Ernst & Young report, stating that the differences in returns on investment in Connecticut, New York, and New Mexico are due to methodology as well as state characteristics. Ernst & Young's reports on New Mexico and New York do not adjust employment for above-the-line or balanced budget requirements that would cause tax increases or budget cuts to pay for the film credits.

For example, Weiner argues that accounting for balanced budget requirements in Massachusetts reduces the fiscal impact of that state's tax credit by 20%. The assumptions in a model of economic impacts can also produce very different results. Weiner points out that two New Mexico studies both used IMPLAN, but one study's estimate was significantly greater than the other's ($1.50 in state and local revenues including $0.94 in state revenues, vs. $0.14 in state revenues).[9]

Another major issue is the absence of a method to distinguish activity that would have occurred without credits. Indeed, Ernst & Young seem to have assumed that all productions receiving a credit in New York would not have filmed there absent the credit. Weiner asserts that this assumption may be acceptable for states starting out with very little film industry, but in New York, which long ago established itself as a film production center, the assumption may be least justifiable. It is also worth noting that Ernst & Young's method for modeling the spillover effects of the credits on non-credited productions makes rather aggressive positive assumptions (a point not commented on by Weiner). Given all of these issues, while there may be a positive

[9] IMPLAN is a commercially-available software program designed to deal with direct and indirect effects of particular economic programs on regional economies. See http://implan.com/V4/Index.php for information.

return on the New York State tax credit, it is unlikely to be as high as $1.90 for each $1 of credit allocated as calculated by Ernst & Young.

Analysis of the LAEDC Impact Study

The New York case study raises interesting questions for California's Film and Television Tax Credit. LAEDC's analysis and report explores whether California will benefit from its credit or whether it will experience a negative fiscal impact.

Background

In June 2011, the Los Angeles Economic Development Commission (LAEDC) published a study of the California Film and Television tax credit. LAEDC determined that for every dollar of tax credit allocated by the State, $1.13 would be returned to the State from the activities associated with the productions that received the credit. We have analyzed the LAEDC report in an effort to determine whether the study findings are plausible. We know which types of productions (e.g., feature, independent feature, movie of the week, etc.) were used in the LAEDC study, general budgetary information about all of the projects that received tax credit allocation letters in the time period examined by LAEDC, and the detailed results of the LAEDC analysis.[10] We also are able to compare the LAEDC analysis to the results of analyses from other states.

However, our analysis of the LAEDC report is limited in that the Minnesota IMPLAN data are proprietary so neither we nor the LAEDC has access to the exact assumptions that went into the LAEDC model. Furthermore, our objective was to examine the LAEDC report and as such, we did not conduct a complete, original economic analysis of the data. Thus, while we cannot say whether the benefit to the state found by the LAEDC is exactly $1.13 for each $1 of tax credit allocated, we can determine whether the results are reasonable and are likely to provide a benefit to the state, as determined by the LAEDC.

The California Film and Television Tax Credit provides $100 million in tax credits each fiscal year (July 1 of one year through June 30 of the following year) for the five years from 2009-2010 through 2013-2014. A one-year extension of the program was recently passed. Feature films with production budgets ranging from $1 million to $75 million, independent films with a minimum production budget of $1 million and qualified expenditures not surpassing $10

[10] This information was provided to us by Christine Cooper at LAEDC and Amy Lemisch and Nancy Rae Stone at the California Film Commission.

million, movies of the week and miniseries with minimum production budgets of $500,000, new television series on basic cable with a production budget for one season of at least $1 million, and television series relocating to California are eligible for the tax credit. For all eligible productions, at least 75% of the principal photography days or 75% of the production budget must take place or be used in California. Independent films and relocating television series receive a 25% credit on all qualified expenditures, while feature films, mini-series, movies of the week, and new television series receive a 20% credit on all qualified expenditures.

The incentive in California is somewhat smaller and more restrictive than in many other states. California's credit ranges from 20-25% depending on the type of production. The median credit across the U.S. is 25%. Highlighting just a few states, Alaska and Michigan provide tax credits that are over 40% or more, New York and Louisiana have 30% tax credits, and New Mexico and Rhode Island have 25% tax credits. Furthermore, in California, 75% of the budget or of the filming must occur in California and except for smaller, independent films, the tax credit in California is not transferable. These restrictions are not found in all states.

For instance, the vast majority of film tax credits in Massachusetts in 2009 had been transferred to insurance companies and other financial institutions (Klowden, Chatterjee, and Hynek 2010; New York State Department of Taxation and Finance 2010; Tannenwald 2010). Because California has such a strong film and television industry infrastructure and a large indigenous work force, California can attract productions with a smaller incentive. This factor, of course, increases the financial benefit that the state will receive from implementing a tax credit incentive program.

LAEDC Analyses & Assumptions

Economic Impact Model

LAEDC used Minnesota IMPLAN to generate their economic impact model and conduct many of its analyses. Minnesota IMPLAN is a respected modeling program that has been used by federal government agencies, state agencies, and universities. Thus, there is no reason to believe that the model used would be inherently problematic.

Typicality of Budgets Analyzed

LAEDC was granted access to the full, itemized budgets of nine productions that received credit allocations during the first application year (2009-2010). The LAEDC report analyzed the data from these nine projects and then extrapolated from those productions to estimate the revenues and expenditures of the 77 productions[11] receiving credit allocations during the first two funding years of the program.[12] That is, for its analysis, LAEDC used the figures from only the nine productions for which it had access to the full budgets.

These productions represented 22% of the allocations. In order to extrapolate their findings to the total sample, the LAEDC multiplied all of their findings by about 4.5.[13] Thus, the entire LAEDC analysis is predicated upon the assumption that the nine budgets for which it had detailed information were in fact, representative of the 77 projects receiving tax credits at the time of analysis. The validity of this assumption is a very important factor to explore when assessing the validity of the LAEDC study.

In many respects, the nine budgets used by the LAEDC were typical of all applicants. LAEDC analyzed films with production budgets ranging from $2.5 million to $75 million. The productions represent most of the types of productions that are eligible for the credit – independent feature film, independent movie of the week, TV series, and small, medium, and large budget films. Furthermore, since most of the work was unionized, wage scales are standardized. Thus, labor costs for all of the productions receiving a tax credit allocation are likely to be fairly uniform.

However, the *total* budgets for these nine productions are not representative of all of the budgets of participating productions. That is, while the nine productions make up just over one-eighth of the total number of projects participating in the program, they represent almost one-fourth of the tax credits allocated. Although the report did not discuss this discrepancy directly, LAEDC did recognize and attempt to account for the difference between the productions it analyzed and the total sample of year-one applicants.

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[11] In the end, seven productions withdrew from the program leaving 70 productions, rather than 77. However, at the time the LAEDC report was published, there were still 77 productions participating using year-one allocations. The unused allocations were rolled over into year two of the program, allowing for additional productions to be granted a tax credit allocation in year two.

[12] Applicants in the first year of the program were granted allocations from the first two fiscal years (2009-2010 and 2010-2011). When LAEDC refers to the first two years of credits, it is referring to the fact that to get the program up and running, the money available for the first two years was allocated in the first year of applications. Thus $198.8 million in tax credits, rather than $100 million were allocated in year one.

[13] The figure 4.5 is about what 22 must be multiplied by to reach 100%.

The LAEDC study notes that the nine productions for which detailed information was available resulted in a total state and local tax impact of $1.08. These nine productions have relatively large budgets and are more likely than the remaining productions to receive a 20% tax credit, rather than a 25% tax credit. In fact, only one of the nine productions included in the LAEDC sample was eligible for a 25% tax credit. Thus the per dollar impact from the nine productions studied is likely to be somewhat greater than the per dollar impact from the remaining 68 productions, which include more productions receiving a 25% tax credit and which have, on average, smaller budgets. Smaller budget films tend to have fewer non-qualifying expenses (such as above-the-line salaries for talent) and importantly, tend to devote a smaller *percentage* of their budgets to non-qualifying expenses. Therefore, the amount of nonqualified expenses relative to the qualified expenses and the amount of the credit will be smaller for the remaining budgets than for the budgets analyzed by LAEDC.

LAEDC's analysis does attempt to account for this discrepancy. Extrapolating, as explained above, from the nine detailed production budgets, LAEDC found that in total, $198.8 million in credits were allocated during the first two allocation years of the program. Using the Minnesota IMPLAN model, LAEDC calculated that, as a result of the productions the credits support, $201 million would be collected in state and local taxes.[14] Since the $198.8 million in credits will be distributed after the taxes are collected, the LAEDC accounts for the time lapse by using the present value of the tax credit.[15] Dividing the amount of taxes collected ($201 million) by the credit allocated ($189.8 million in 2011 dollars), they find that for all 77 productions utilizing the first two years of funds, $1.06 will be returned for every $1 credited.

When LAEDC does this same calculation for the nine productions for which they have full budgetary information, they find that $1.08 will be returned for every $1 credited. LAEDC uses the smaller rate of return in order to account for the fact that the productions in their analysis have qualifying expenditures that are nearly twice as high as those of participating productions as a whole. The consequence of this fact (i.e., a smaller percentage of expenses subject to the credit means a larger percentage of expenditures not subject to the credit) is that estimates based on the subset of productions examined are likely to overstate the overall return

[14] LAEDC used both state and local taxes in their analysis because local tax receipts are an important part of the general benefit to the state of productions being made in California.

[15] One issue that is not addressed in the LAEDC report is the fact that setting aside this money in the California budget means that spending on some other program or programs will be foregone. The study does not take this opportunity cost into account in weighing the costs and benefits of the California Film and Television Tax Credit.

for the state. Thus, the LAEDC analysis concludes that before taking into consideration ancillary production, the credit will garner $1.06 in state and local taxes for each $1 allocated, substituting the smaller multiplier figure based on the full sample.

Whether this is the exact reduction warranted by the difference between the budgets used for the analysis and the total set of productions allocated credits during the first two funding years is hard to say. The full budgets for all of the productions are not available. However, LAEDC did attempt to take into consideration budgetary and allocation differences in their analysis.

Job Creation

In addition, the LAEDC analysis determined that 21 jobs are created for each $1 million in qualifying expenditures. This number is an output of the economic modeling program that the LAEDC used (Minnesota IMPLAN) to conduct their analyses. Since, Minnesota IMPLAN is respected and widely used, as noted above, the model produced for this analysis is likely to be reasonable. The modeling program uses the direct impact, indirect impact, and induced impact[16] of film and television productions being produced in California to calculate how many jobs will be created for each $1 million in qualifying expenditures. Since job creation represents the number of jobs created per $1 million in qualifying expenditures, it is a straightforward calculation to determine how many jobs would be created by all of the productions participating in the program.

Thus, LAEDC found that 4,440 jobs would be created by the nine productions that they were able to study in detail and 20,040 jobs would be created by all 77 productions receiving credit allocations during the first two funding years of the program.[17] It is important to note that the jobs reported here are annual positions with a 95% conversion rate to full-time equivalent

[16] Direct impact is defined as the economic impact of activities coming directly from the production of the movie or TV show. The monetary figures for this economic impact are drawn directly from the nine budgets analyzed by LAEDC. Indirect impact is defined as the economic impact of goods and services related to the production, for example the cost of materials and labor paid by the set designer to build a set. Induced impact is defined as the economic impact of spending by the households of production employees.

[17] Using the project budgets, LAEDC found that the 77 productions in the program had $970.3 million in qualifying expenses. Note that 21 times 970.3 equals 20,376 jobs, not 20,040 as reported by LAEDC. Presumably this difference is due to rounding.

jobs (FTEs). Thus, the 77 productions receiving participating in the tax credit program are estimated to create 19,038 annual FTEs.[18]

Ancillary Production

LAEDC assumes $100 million in follow-on or ancillary production for the 77 productions taking part in the first two funding years of the tax credit allocation program. This ancillary production includes later projects that will film in California because a producer was already in California due to a project that was part of the incentive program. It is unclear if ancillary production includes video games or marketing products related to a participating production that are also produced in California. The $100 million of ancillary production is a consensus of estimates provided by people in the film and television industry. Therefore, it was not possible to directly measure its impact and to thus confirm or disconfirm the LAEDC analysis of the benefit of the tax credit on revenues to the state from ancillary production.

Certainly whatever ancillary production is created in California as a result of the activities of productions participating in the incentive program will be a boon to the California economy. That additional production may not receive a tax credit, so all revenues will be used in their entirety to add to state tax revenue. However, as noted below (in the discussion of production flight), the LAEDC report assumes that only films receiving credits will be produced in the state. If this assumption does not hold, then not all of the revenue coming from ancillary production will be a result of the tax credit.

Nevertheless, LAEDC calculates that the $100 million in ancillary production creates at least $10 million in state and local taxes,[19] resulting in an additional $0.07 per $1 of tax credit allocated. While this calculation may not be unreasonable, it also is not verifiable. It is possible that the economic activity created by ancillary production is even greater, but it is also possible that it is less. Furthermore, as with the other analyses, it is not possible to replicate the induced impacts, which are determined using assumptions created by the modeling program.

[18] As with other job creation measures, there are follow-on effects that are difficult to measure. For example, to the extent that jobs created by the tax credit are filled by unemployed workers, this will decrease the average duration of unemployment, which will decrease the cost of unemployment insurance premiums paid by employers. This in turn, will tend to encourage employers to locate, remain, or start up within the state. However, there is no practical way to quantify this effect.

[19] The figure of $13 million is the number provided in Exhibit 4-1, p. 13 of the LAEDC report. These numbers are calculated using the Minnesota IMPLAN model.

Film Related Tourism

As with most analyses of film and television industry incentives, film related tourism is not included in the analysis. This is because it is very difficult to determine the precise amount of tourism and spending created by a particular production. However, it is clear that productions with a recognizable location attract tourism to that location. For instance, the vineyards highlighted in the movie, *Sideways*, no doubt received a surge of visitors after the movie was released. Thus, this effect is an unmeasured, but not insignificant source of revenue for the state, directly related to keeping productions in the state.

Direct, Indirect, & Induced Impacts

The direct, indirect, and induced impacts are the three types of economic impact that are calculated in any economic benefit analysis. The direct impact is simply the impact of the actual spending on the production. This figure is obtained from the budgets. This figure is likely to be fairly accurate. However, as noted earlier, since the budgets on which the analysis is based over-represent big budget films[20] the total production spending for all 77 productions may be somewhat overstated. The indirect impact is the impact of spending related to the production, but not in the budget such as the money spent by the set designer to create the set. The indirect impact is created using a government input-output table of all spending related to the film and television industry and can be expected to be accurate.

The induced impact is the impact of added spending, unrelated to the production but stimulated by the production's spending, by everyone associated with the production and their households. This reflects the fact that people receiving income from the production will spend some of that income. The induced impact is estimated by using an economic impact model that utilizes a number of assumptions. Again, LAEDC used Minnesota IMPLAN to generate their economic impact model. It is not possible to know what all of the assumptions in the model are. However, since Minnesota IMPLAN is a respected modeling program, the model is unlikely to be inherently biased or problematic.

[20] Again, the budgets analyzed represent just over one eighth of the projects in the program, and almost one fourth of the qualifying expenses.

Multiplier

LAEDC's analysis finds a multiplier of 2.5. The multiplier represents the amount by which the direct spending is multiplied to get the total output, which includes direct spending, indirect spending, and induced spending. The multiplier takes into account three elements, as noted above – direct spending, indirect spending, and induced spending. Direct spending comes from the budgets provided. Indirect spending comes from a government produced input-output table, so it should be reliable. The model determines the induced spending.

This approach is a conventional way to come up with such estimates, but it is indeed an estimate dependent on the economic assumptions built into the model. While not in its report, LAEDC's analysis found that direct spending on the 77 films that received funding for the first two funding years came to $1.575 billion, indirect spending came to $1.340 billion, and induced spending amounted to $1.525 billion.[21] These figures indicate a household savings rate of about one-third.[22] In other words, the LAEDC is estimating that on average, people spend about two-thirds of their income on consumption. This figure is quite conservative and leads us to conclude that the impact of induced spending (the amount spent by households of people affiliated with the production on expenses unrelated to the production) is very reasonable. Thus, it follows as well that the multiplier used by the LAEDC is likely not exaggerated.

Production Flight

Two of the most critical assumptions of the LAEDC study are that *all* productions that do not receive a tax credit allocation will leave California and that *only* productions that receive a credit will stay and film in California.[23] Research cited in the literature review suggests that tax credits and other incentives do work to lure productions to states where they may not otherwise have been made. However, it is not clear that producers only film where they have an incentive.

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[21] These figures were reported in personal communication with Christine Cooper at the LAEDC.

[22] Initial spending (direct +indirect) X 1/(1-savings rate) = total spending (direct + indirect + induced). Solving the equation using the figures provided by LAEDC results in a savings rate of 34%.

[23] The Motion Picture Association of America noted that 111 films that were qualified to receive the tax credit began production in California in 2010. Based on their estimated start dates, 46 films that began filming in 2010 received tax credits. Presumably the remaining 65 films produced in California without receiving a tax credit. This argues for limiting the size of the tax credit and continuing the current restrictions on the types of productions that are eligible to apply for the program since a number of productions are made in California without a tax credit. However, the assumptions made in the LAEDC report are most relevant to the population of producers who are eligible for and interested in receiving a tax credit.

All of the producers who were able to begin production in the first funding year, who were working on eligible productions and who applied for the credit in the first round of applications, eventually received a tax credit allocation letter. In the second year of applications, some productions remained waitlisted and did not receive an allocation letter. Some of these productions never began filming because they were never green lit or were unable to come up with the needed funding to film. However, 14 waitlisted productions did begin filming. Among these 14 productions, five filmed in California without receiving a tax credit and nine began filming outside of the state.

Thus, it is clear that this first assumption of the LAEDC does not provide a complete picture of production location decision making – not all productions left when they did not receive a credit and not only productions with a credit filmed in California. However, most productions without a credit did leave the state. Notably, all of the productions that filmed in California while on the waiting list were independent films.

Independent films are likely to have relatively smaller budgets and the costs of scouting a new location and relocating are more than what these productions would receive in credits from another state. Furthermore, any portion of a production that is made after receiving a tax credit allocation letter is eligible for the tax credit, a benefit on which some waitlisted independent producers may have been counting. So, the existence of the tax credit no doubt influenced these producers' decision to film in California.

While all of the productions that stayed and filmed in California despite not receiving the tax credits were independent productions, all of the bigger budget productions that were made left the state after being put on the waiting list. Small, independent films may be a special case because they often cannot afford to leave the state. But as long as they remain a part of the California Film and Television Tax Credit program, they must be included in the analysis of the benefit of the credit to the state.

Nonetheless, the fact that five of the applicants filmed in California without receiving a tax credit, rather than leaving the state to film elsewhere, changes the economic impact of the tax credit. These five productions had budgets totaling \$20.2 million and represent 8.4% of the total production budgets (\$240.2 million) of waitlisted productions.[24] We cannot be certain of the exact proportion of spending by productions that would film in the state without an incentive.

[24] Total production budgets for waitlisted productions were provided by the California Film Commission.

However, based on what actually happened when there was a waiting list in the second application year of the California tax credit program, our best estimate is that 8.4% of production spending would come from productions that would film in the state even with no incentive. This assumption implies that the state is paying for some productions that would have provided jobs for Californians and stimulated the California economy anyway.

Therefore, the benefit to the state of the tax credit will not be quite as high as $1.13 for every $1 in tax credit allocated. Rather, the benefit will only be returned for those tax credit recipients who would have left the state without an incentive. The incentive is wasted on those who would have stayed and filmed in California anyway. In this case, $220 million out of $240.2 million or 91.6% of the tax credit applicants are estimated to flee absent an incentive. Hence, the state will likely realize as much as 91.6% of the economic benefit of the tax credit, or $1.04 for every dollar of tax credit allocated. It appears then, that while the California Film and Television Tax Credit most likely creates an immediate economic benefit for the state, it will not be quite as large as what was calculated by the LAEDC analysis.

LAEDC Analysis: Conclusion

The analysis presented by LAEDC is reasonable. Minnesota IMPLAN, the program it used to create the economic impact model, is respected and used by government and academia. LAEDC used nine productions, representing a variety of production types on which to base its analyses. The importance of the job creation component of the LAEDC analysis should not be overlooked. LAEDC estimates that more than 19,000 full time equivalent positions were created directly and indirectly by the productions participating in the tax credit program. Since unemployment in California has been high in the aftermath of the Great Recession, a program that can create a significant number of jobs should not be dismissed.

However, the LAEDC analysis does have some problems that could overestimate the efficacy of the program. The productions on which the LAEDC analyses were based represented a variety of production types, but overrepresented the proportion of the total tax credit that was used. This will have the effect of reducing the impact of the tax credit. While the LAEDC did account for this reduced impact, we were unable to determine if they did so adequately. It is also unclear where the numbers for ancillary production come from and whether the benefit ascribed to this additional production is accurate. Nonetheless, there certainly is some benefit from

ancillary production. There is also some benefit from entertainment tourism that is unaccounted and which would help to compensate if there were any overestimating of ancillary production benefits.

However, most importantly, while many producers are swayed by the enticement of a tax credit in their production location decision making, the assumption that all productions that do not receive a credit will leave the state and only productions that do receive a credit will stay, is not true. The fact that this assumption does not bear out reduces the economic impact of the tax credit from the state collecting $1.13 for every $1 it allocates in tax credits to an estimated recouping of $1.04 for each dollar allocated. Again while there likely is a benefit to California as a result of the tax credit, it is not quite as large as what was estimated by the LAEDC.

A number of other states have not actually found a benefit from their incentive programs. While the tax incentives may be attracting production, most states are losing revenue as a result of the tax credits they offered. For instance, a report published by the Center on Budget and Policy Priorities found that Massachusetts, Connecticut, Louisiana, Michigan, Pennsylvania, and Arizona have all suffered revenue losses as a result of their film industry tax credits (Tannenwald 2010).

However, there is evidence that some productions will leave California if there is no incentive in the state. LAEDC notes that incentives across the U.S. and around the world have created a shift away from filming in California. Indeed, California dropped from having 40% of movie and video industry employees in North America in 1997 to having 37.4% of these employees in 2008. Nonetheless, as noted previously, after initial boosts following the implementation of tax credits, most states have stopped seeing large increases in production related employment.

However, states such as Louisiana, which are not yet true competitors of California, have seen recent growth. Louisiana experienced a jump in employees related to film production immediately following the establishment of their tax credit in 2002, which held on until the effects of the recession were felt in 2008. This increase in employees may imply an increase in production. Furthermore, movie production and video production related establishments have continued to increase slowly from 49 in 2002 to 71 in 2009 (U.S. Census Bureau, 2011). This is a sign of increased infrastructure. Thus Louisiana is clearly taking a long-term view that incentives will build up the film industry in that state. Without a challenge from California

coming from an incentive program, states like Louisiana have the potential to develop into real competitors.

In addition, New York and Canada have the largest share of the industry outside of California and like California have strong infrastructure and a qualified indigenous workforce. Both of these regions have implemented tax credits and both have seen an increase in production activities, and, at least in the case of New York, what may be a positive return on the tax credit. The incentives in New York and Canada are, indeed, cause for concern in California as they may give these locations a competitive edge. Thus, the California tax credit may play a vital role in keeping production in California, and sustaining the competitiveness of the California film/TV industry over the long run.

Conclusions

Previous research, our analysis of the survey of producers, and the LAEDC report all support the idea that incentives are a major factor in production location decisions. However, incentives are not the only factor that is important to producers when they are deciding where to produce a film or television show. A well-trained workforce, low cost labor, location, and film/TV industry infrastructure all contribute to the final decision about where to film. The analysis here demonstrates that the California Film and Television Tax Credit most likely has small short-term benefits and important long-term benefits.

Without incentives, some productions may be pulled out of California. Over time, this effect would reduce California's dominance in the film industry. Right now, for example, California workers are sometimes hired to work on out-of-state productions. If California is no longer the leader in the industry, then eventually, California workers may not be needed to help on out-of-state productions, as other states build their infrastructure and indigenous workforce.

In addition, if other states' tax credit advantage leads them to build up their skilled production workforce, state-of-the-art facilities, and supporting industries, California's overall comparative advantage will diminish. There is no way to put a dollar amount on the benefit of maintaining the state's dominance in the long-run. However, both the immediate and longer-term economic benefits of the incentive program need to be considered when deciding on the ultimate benefit of the incentive program.

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CHAPTER 2

Too Good to be True? How State Charitable Tax Credits Could Increase Federal Funding for California

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"Bucks loves strategies that allow you to beat the system, especially when you can do some good in the process."

—from the "Bucks" blog, *New York Times*, December 22, 2010

I. Introduction

Despite pervasive disagreement over the size of government and the level of taxes required to pay for it, Californians are generally united in the view that the state is getting a raw deal vis-à-vis the federal government. Polling data consistently show that roughly two-thirds of Californians think the state should receive more federal assistance, including a majority of Democrats, Republicans and independents.[1] Playing on these sentiments during his gubernatorial campaign in 2003, Arnold Schwarzenegger announced, "By the time I'm through with this whole thing, I will not be known as the Terminator—I will be known as the Collectinator!"[2] Jerry Brown sounded a similar theme seven years later, vowing to "stop leaving federal money on the table."[3] Whatever the merits of these bipartisan proclamations as a political matter, there is little indication that Washington is prepared to rework the distribution of federal spending or taxes in California's favor.

Yet not all policies directing additional federal support to the state require Congressional approval. This chapter considers a legislative strategy for increasing federal funds that California could enact on its own initiative—i.e., the adoption of a state income tax credit for charitable contributions that augment or defray selected state or local government expenditures. If respected by federal tax authorities, such a credit would effectively enable taxpayers to convert state income tax payments to charitable contributions on their federal income tax returns. This result would reduce the federal income tax liability of taxpayers subject to the federal alternative minimum tax (AMT), which disallows deductions for state and local taxes but permits them for charitable contributions. In addition, if the state were to adopt a transferable charitable tax credit, it

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[1] Public Policy Institute of California, Californians and their Government (http://www.ppic.org/content/pubs/survey/s_110mbs.pdf).
[2] See, e.g., Warren Olney, *Can the Terminator Be the Collectinator, Too?* KCRW, Which Way, LA? (February 16, 2005).
[3] Anthony York, *Campaign Notebook: Brown Goes Negative, Whitman Goes Big*, Capital Weekly, September 16, 2010.

could give taxpayers the ability to convert ordinary income to capital gains, reducing their federal income tax liability by as much as 20 cents on the dollar based on current tax rates. In both cases, the state government would share in the federal tax savings to the extent that the charitable tax credit does not fully compensate taxpayers for their donations.

While this outcome may sound too good to be true, recent legal guidance from the Office of Chief Counsel of the IRS appears to provide support for the strategy. Asked to opine on the effects of a state income tax credit for charitable donations, the Chief Counsel in 2010 concluded that the taxpayer was allowed a deduction for the full amount of her charitable contribution to a state agency despite the fact that she received a state income tax credit for some (unspecified) percentage of that amount. A recent U.S. Tax Court decision appears to support the IRS position, accepting a couple's charitable contribution deduction even though the gift entitled them to a 100 percent state tax credit for a portion of their gift.[4] This conclusion is consistent with the federal income tax treatment of state tax deductions for charitable contributions, which are generally ignored in calculating the amount of a donor's federal deduction, but it is arguably at variance with other legal authority requiring taxpayers to reduce the amount of her charitable contribution deduction by the amount of cash and the value of any property or services received in exchange for the gift.

Our analysis considers the federal income tax consequences of state charitable tax credits and critically evaluates the Chief Counsel's memorandum on this issue. We also consider the significance of the Chief Counsel's analysis for SB 1356, draft legislation recently proposed by California State Senator Kevin de León that would permit an income tax credit for certain contributions to a Higher Education Investment Tax Credit Program Special Fund. The HEITC program offers a framework for considering how California might take advantage of the IRS Chief Counsel's 2010 memorandum. Our analysis casts doubt on the Chief Counsel's conclusions and thus also calls into question the federal tax benefits supposedly associated with SB 1356. Nevertheless, given the IRS position, the HEITC program deserves careful consideration as a means for California to

[4] Tempel v. Commissioner, 136 T.C. No 15 (2011).

pursue fiscal "self-help" via creative tax planning. While we believe the HEITC strategy SHOULD NOT produce the federal tax benefits it purports to produce, IRS guidance appears to provide a legal opening for those hoping to act on the state's Collectinator impulses.

II. Mechanics of Federal Tax Law

Understanding the possible benefits to California of adopting an income tax credit for charitable contributions requires a brief overview of relevant federal tax rules, including the deduction for charitable contributions, the deduction for state and local taxes, and the differential treatment of charitable contributions and state and local taxes for purposes of the federal alternative minimum tax.

A. *Charitable Contributions*

Section 170 of the Internal Revenue Code allows a deduction for "any charitable contribution… payment of which is made within the taxable year."[5] Significantly, the statute goes on to define a charitable contribution as a "contribution or gift to or for the use of", [inter alia], "*a state*, possession of the United States, or any political subdivision of any of the foregoing … but only if the contribution or gift is made for exclusively public purposes."[6] While charitable gifts to state governments are less common than donations to other types of charitable organizations, the statute is clear that the term "charitable contribution" encompasses such gifts.[7]

Like all charitable donations, gifts to state and local governments are subject to the general rules and limitations applicable to charitable contributions, including those set forth in Treasury regulations or developed through judicial doctrines over the years. Of particular relevance to our analysis is the limitation set forth in Treasury Regulation

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[5] 26 U.S.C. section 170(a).

[6] 26 U.S.C. section 170(c) (emphasis added).

[7] Of course, gifts to state colleges and universities (as well as public schools at the K-12 level) are not at all uncommon, though those contributions would be deductible as charitable gifts even if the schools were private because the statute permits deductible contributions to educational organizations. For a thorough review of the different types of governmental entities and affiliates for purposes of various federal income tax rules, including the charitable contribution deduction, see Ellen Aprill, *The Integral, the Essential, and the Instrumental*, 23 Journal of Corporation Law 803 (1998).

section 1.170A-1(h)(1), providing that "no part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for … goods or services (as defined in section 1.170A-13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer—(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) Makes a payment in an amount that exceeds the fair market value of the goods or services."[8] The term "goods and services" is then defined to include "cash, property, services, benefits, and privileges."[9]

This rule accords with the common sense notion that a charitable gift entails parting with something of value. To the extent that the taxpayer is receiving an item of value in exchange for her contribution, it would seem appropriate to reduce the amount of the taxpayer's charitable contribution deduction by the fair market value of whatever is received in return. Accordingly, the regulations specify in the very next paragraph that any otherwise allowable charitable contribution deduction cannot exceed "the excess of (A) The amount of any cash and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over (B) The fair market value of the goods or services the organization provides in return."[10]

This approach is no doubt familiar to anyone who has ever made a donation to organizations such as NPR or PBS during one of their pledge weeks. It is not uncommon for these (and other) organizations to provide donors with some item of value in exchange for their gift. For example, in exchange for a gift of $500, PBS might send a donor the complete DVD set of the Ken Burns documentary on the Civil War. If that DVD set has a fair market value of $100, the taxpayer's charitable contribution will be limited to $400—i.e., the excess of the amount contributed ($500) over the fair market value of the goods received in exchange ($100).

Surprisingly little attention has been given to the interaction between the rules just summarized and the availability of *state* income tax benefits arising from charitable

[8] 26 C.F.R. §1.170A-1(h)(1).
[9] 26 C.F.R. §1.170A-1(f)(5).
[10] 26 C.F.R. §1.170A-1(h)(1).

gifts.[11] It is not uncommon for states with an income tax to follow the federal tax code in providing a deduction for charitable contributions. Thus, in the example just mentioned, the taxpayer may be able to claim a $400 charitable contribution deduction not only on her federal Form 1040, but also on her state income tax return. Assuming a federal tax rate of 35 percent and a state tax rate of 10 percent, a $400 deduction will reduce the taxpayer's federal income tax liability by $140 and reduce her state income tax liability by $40.

In most cases, the state tax benefits arising from a charitable donation are not likely to be significant—in part because state income tax rates are significantly lower than federal income tax rates. In addition, as will be discussed further below, the reduction of the taxpayer's state income tax liability has its own federal income tax consequences—i.e., reducing the amount of otherwise deductible state income tax payments.[12] However, matters are complicated somewhat—and the stakes potentially increased—when a state offers an income tax *credit* for charitable gifts rather than a deduction. *Unlike a deduction, a credit is a dollar-for-dollar reduction in a taxpayer's tax liability.* Whereas the dollar value of a deduction is a function of the taxpayer's marginal tax rate, the dollar value of a credit is a function of the "credit percentage" available under the credit.

For example, assume for the sake of analysis that a state adopts a 40 percent income tax credit for donations to PBS and taxpayer Dora makes a $1,000 donation to her local PBS station. Assume further that Dora's marginal tax rate under her state's income tax is 10 percent. If Dora were to claim a state charitable contribution deduction for her $1,000 donation, it would save her $100 in state income taxes. By contrast, an income tax credit with a 40 percent credit percentage would have the effect of reducing Dora's state income tax liability by $400. Deductions and credits are merely two different ways of

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[11] An exception is Naomi E. Feldman & James R. Hines, Jr., *Tax Credits and Charitable Contributions in Michigan* (October 2003) (http://www.bus.umich.edu/otpr/WP2003-7.pdf).

[12] As discussed *infra*, the reduction in state tax liability arising from the state-level deduction can also *increase* the taxpayer's federal income tax liability to the extent that the taxpayer's state and local tax deductions are reduced by virtue of the reduction in state tax liability. In this situation, the after cost of the gift is equal to the gross gift multiplied by $(1 - \mathrm{f})(1 - \mathrm{s})$, where f is the federal marginal tax rate and s is the state marginal tax rate.

accomplishing the same result; however, credits give policymakers more flexibility insofar as the subsidy rate can be set independently of marginal tax rates.[13]

In recent years, some states have adopted state income tax credits with extraordinarily high credit percentages, including some with a 100 percent state income tax credit.[14] It is worth pausing for a moment to reflect on what it means for a state to offer a 100 percent income tax credit for a charitable gift. Can such a transfer even be considered a "gift"? Returning to our Dora/PBS example, assume for the moment that Dora's state permits a 100 percent income tax credit for donations to PBS up to an amount of $1,000. Under the terms of this statute, a $1,000 "gift" to PBS would enable Dora to reduce her state income tax liability by $1,000. In effect, Dora is directing the state to transfer $1,000 of what would otherwise be state income tax revenue to PBS.[15] Such a scheme raises some interesting questions about politics and democratic theory (e.g., Who should decide how that $1,000 is spent? A state's elected representatives? Or the taxpayers who make those donations?), but those questions are beyond the scope of our analysis.

For our purposes, the point to emphasize is that a 100 percent state income tax credit has the dual effect of (1) increasing the taxpayer's charitable contributions by the amount

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[13] William J. Turnier and Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions and Exemptions*, 36 Florida Tax Review 1003 (1984). Some commentators prefer credits over deductions on the grounds of both efficiency and equity. *See*, *e.g.*, Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA Law Review 1389, 1429 (2004) (examining arguments for converting the deduction for state and local taxes to a flat-rate credit); *see also* Lily L. Batchelder, Fred Goldberg, Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stanford Law Review 23 (2006).

[14] For example, the National Conference of State Legislatures reports that several states have adopted income tax credits for donations to qualifying "school tuition organizations." These include programs with credit percentages ranging from 50-100 percent. (see NCSL, *Tuition Tax Credits: Overview*, http://www.ncsl.org/issues-research/educ/school-choice-scholarship-tax-credits.aspx). The availability of these tax credits for donations to STOs in Arizona was the subject of the U.S. Supreme Court's decision in Arizona Christian School Tuition Organization v. Winn, 563 U.S. __ (2011).

[15] In the Supreme Court decision cited in Footnote 14, *supra*, Justice Kennedy observes, "When Arizona taxpayers choose to contribute to STOs, they spend *their own money*, not money the State has collected from respondents or from other taxpayers" (emphasis added). This conclusion is relevant to the question of whether the parties challenging the constitutionality of the Arizona statute on Establishment Clause grounds had standing to pursue the lawsuit. For an opposing perspective, noting the fundamental interchangeability between government expenditures and tax credits, see Justice Elena Kagan's dissenting opinion in the same case.

donated, and (2) reducing the taxpayer's state income tax payments by the same amount. In effect, the availability of a 100 percent state income tax credit for charitable gifts permits the taxpayer to "convert" what would otherwise be state tax payments to charitable donations. Where the donee is not a private organization, such as NPR, PBS or United Way, but rather the state government itself, the only real change is one of labeling. In other words, if Dora makes a $1,000 gift to her state, and is thereby allowed to claim a $1,000 state income tax credit, all she really has done is to convert what would otherwise have been a $1,000 state income tax liability into a $1,000 charitable gift.

B. *The Deduction for State and Local Taxes & the Rise of the AMT*

Under section 164 of the Internal Revenue Code, taxpayers are allowed a deduction for state and local property taxes, income taxes and, in certain circumstances, retail sales taxes.[16] This longstanding provision of federal tax law should have the effect of negating any benefit associated with converting state income tax payments to a charitable gift. In the example described above, if Dora claims a 100 percent state income tax credit for her $1,000 donation to PBS, all she has done is to reduce her (federally deductible) state income taxes and increase her (federally deductible) charitable contributions. Because both state income tax payments (section 164) and charitable contributions (section 170) are deductible for purposes of the federal income tax, converting a $1,000 transfer from one category to the other should not have any meaningful federal income tax consequences.

Significantly, however, state income tax payments and charitable contributions are treated differently for purposes of the federal alternative minimum tax. Whereas charitable contributions are deductible for both the regular income tax and the alternative minimum tax, state and local taxes are deductible only for the regular income tax. More precisely, section 56(b)(1)(A)(ii) of the Internal Revenue Code provides that "in determining the amount of the alternative minimum taxable income… no deduction shall be allowed…for any taxes described in paragraph (1), (2) or (3) of section 164(a)." As a result of this provision, taxpayers subject to the AMT typically enjoy no federal income tax benefit from the deduction for state and local taxes. Thus, while a taxpayer subject

[16] 26 U.S.C. section 164.

only to the regular income tax should generally be indifferent to the classification of a payment as a charitable contribution or a state tax payment, an AMT taxpayer will generally prefer to have a payment classified as a charitable contribution rather than a state tax payment because the former is deductible while the latter is not.[17]

Until recently, the alternative minimum tax was a relatively insignificant feature of the U.S. fiscal structure. The AMT was originally enacted as part of the Tax Reform Act of 1969 in response to revelations that 155 taxpayers with income in excess of $200,000 had zero federal income tax liability in 1966.[18] Congress responded with the AMT to ensure that wealthy taxpayers pay at least some minimum amount of income tax. Over time, various changes to the AMT structure, along with the fact that its key parameters (e.g., the AMT exemption, the breakpoint between the AMT tax rates) were not indexed for inflation, worked to convert the AMT from a relatively minor add-on tax to a fairly significant feature of the U.S. federal income tax. In very general terms, the AMT can be described as having a broader base (because it features fewer deductions) and lower rates (with a top rate of 28 percent, as compared to 35 percent) than the regular income tax.

By far the most significant AMT preference item is the deduction for state and local taxes, accounting for more than two-thirds of total AMT preferences and adjustments in recent years.[19] As a result, AMT participation rates are highest in those states where state and local tax burdens are the greatest. The Urban-Brookings Tax Policy Center has estimated that, in 2007, "families in high-tax states were almost three times more likely to face the AMT than those in low-tax states." States with the highest number of total returns featuring AMT liability are California, Connecticut, Maryland, Massachusetts, New Jersey, and New York.

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[17] Even outside the AMT context, taxpayers should generally prefer deductible charitable contributions to non-deductible state and local taxes, such as retail sales taxes or gas taxes, suggesting that a tax credit scheme aimed at converting state sales or gas tax liability to charitable contributions would be subject to the same type of analysis described in the text. Tax credits are of course far less common in these contexts than in the income tax context.

[18] Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, *The Expending Reach of the Individual Alternative Minimum Tax*, Urban/Brookings Tax Policy Center (May 2005).

[19] Tax Policy Center, Reconciling AMTI and Taxable Income for AMT Taxpayers (December 21, 2010) (deduction for state/local taxes accounted for more than 68% of AMT adjustments and preferences for 2008) (http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf).

C. *California AMT Data*

IRS data reveal more detail about the operation of the AMT in California. For taxable year 2010, approximately 4.5 percent of federal income tax returns filed in California showed some AMT liability. Nearly all of those returns (96 percent) were filed by taxpayers with adjusted gross income over $100,000, and three-quarters were filed by taxpayers with AGI in excess of $200,000.[20] Thus, as is true throughout the country, AMT liability of Californians is concentrated in the top decile of the income distribution.[21] For each of these taxpayers, an increase in their state tax liability will have no effect on their federal income tax liability because of the non-deductibility of state and local taxes under the AMT. However, an increase in charitable contributions would reduce their federal income tax liability by the amount of the contribution multiplied by the marginal tax rate, which for those subject to the AMT would be either 26 or 28 percent.[22]

III. Understanding the Effects of a California State Charitable Tax Credit

The differential treatment of state and local taxes and charitable contributions under the AMT creates an opportunity for tax planning. The tax planning we have in mind is not the conventional variety, where an individual or business entity engages the expertise of a tax lawyer or accountant with an eye toward minimizing their tax obligations. Rather, what we envision is state legislation enacted specifically for the purpose of exploiting the federal tax code's differential treatment of these two types of payments.

At this point, we offer our analysis merely as a thought experiment in the hopes of revealing the intuition underlying the idea. Our aim here is not to endorse a California state charitable tax credit—indeed, we have some doubts as to its viability as a means of capturing additional federal resources for the state. Rather we will highlight the technical

[20] IRS Statistics of Income (2010) (available at http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2).
[21] See Emmanuel Saez, *Striking it Richer: The Evolution of Top Incomes in the United States (Updated with 2009 and 2010 estimates)*, Figure 2 (March 2, 2012) (noting that the breakpoint for the top decile, based on national figures was $108,000 in 2010).
[22] 26 U.S.C. section 55(b)(1)(A)(i).

legal questions that would need to be answered to ensure that such a credit would have the desired effects.

A. *The (Potential) Federal Tax Benefits of a California Charitable Tax Credit*

The potential benefit of a state income tax credit for charitable contributions is best understood with an extreme example—i.e., a 100 percent California state income tax credit for donations to a California State Charitable Contribution Fund (CSCCF)—that we will refer to as *Example A*. Let us assume that the purpose of this fund will be to undertake some sort of activity that has the effect of defraying state general fund expenditures. Taxpayer Joe, with federal adjusted gross income in the $400,000-$500,000 range and subject to the federal AMT, plans to contribute $10,000 to this fund.

If respected as a charitable gift, this contribution will entitle Joe to (1) a $10,000 income tax credit on his California state income tax return, and (2) a $10,000 charitable contribution deduction on his federal income tax return. The $10,000 California state income tax credit fully compensates Joe for the contribution. Thus, while his state income tax liability has decreased by $10,000, his total payment to the state has not changed; it's just that $10,000 is directed to the CSCCF instead of to the state's general fund. From the state's perspective, this should be simply an accounting maneuver, at least insofar as CSCCF resources are used to defray general fund expenditures.

By contrast, the effect on Joe's federal income tax liability is more meaningful. While the $10,000 reduction in Joe's state income tax payments has no effect (since he is subject to the AMT and thus enjoys no benefit from state and local tax deductions), his charitable contribution deduction has increased by $10,000. At a marginal tax rate of 28 percent, Joe should experience a reduction in his federal income tax liability of $2,800. Thus, merely by relabeling the $10,000 (from "tax" to "gift"), Joe saves $2,800 in federal taxes.[23]

[23] A comparable benefit arises when a taxpayer makes a federally deductible donation and is granted a state credit for some state or local tax that is not deductible for purposes of the federal income tax. This would be the case, for example, with regard to a retail sales tax credit or a gasoline tax credit. Except in the relatively rare case of a taxpayer electing to deduct sales taxes in lieu of income taxes, these taxes are generally not deductible for anyone. Thus, to the extent that a charitable contribution gives rise to (1) a federal income tax deduction for the full amount

The State of California may wish to adopt such a scheme solely for the benefit of taxpayers like Joe—or it may decide to offer a state income tax credit for some amount less than 100 percent in an effort to capture some portion of that $2,800 for public expenditures or other purposes. For example, let's modify our hypothetical slightly (*Example B*) and assume that the state income tax credit bears a credit percentage of 80 percent instead of 100 percent. Under that scenario, Joe's contribution of $10,000 would reduce his state income tax liability by only $8,000, with the result that his net payments to the state have increased by $2,000 as a result of his gift to the fund. However, the federal tax treatment of the transfer would remain the same—i.e., his federal income tax liability would be reduced by $2,800 by virtue of the increase in his deductible charitable contributions by $10,000. In effect, where the state income tax credit is less than 100 percent, the state is able to claim a share of the federal tax savings arising from the transfer.

At this point in the analysis, the reader is likely thinking (or, if not, perhaps should be), "this can't work." After all, the state income tax credit scheme described above has all the markings of a transparent tax avoidance scheme—i.e., mere paper shuffling and relabeling devised for the purpose of reducing federal tax liabilities. The fact that a state government is initiating the scheme does not make it any less objectionable on the grounds of "substance over form" or other such judicial anti-tax avoidance doctrines. The "right" answer, it seems to us, is that the taxpayer's charitable contribution deduction should be reduced by the value of the state tax benefit arising from the transfer. Thus, in *Example A* above, Joe's charitable contribution deduction for the $10,000 transfer to the CSCCF *should* be zero. In *Example B*, the allowable charitable contribution deduction *should* be $2,000. In both cases, to allow a charitable contribution deduction of $10,000 on the federal return is to ignore the significant state tax benefit arising from the income tax credit. This result seems to follow from the Treasury regulations discussed above.

Despite our attraction to these answers as the "correct" result, we see two problems. First, as explained in more detail below, the IRS has recently taken a contrary view,

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of the gift, and (2) a state tax credit for one of these non-deductible taxes, the effect is to convert the payment of a non-deductible tax to a deductible gift.

concluding that "a state or local tax benefit [e.g., a state income tax credit for donations of cash or property to a state agency] is treated for federal tax purposes as a reduction or potential reduction in tax liability" and "not as consideration that might constitute a *quid pro quo*, for purposes of §170…" Second, for the IRS to hold otherwise would likely require a broader reconsideration of the longstanding principle that "[t]he tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself." These passages are quoted from the Chief Counsel's 2010 memorandum on this issue, to which we now turn.

B. *IRS Chief Counsel Memorandum 201105010*

In early 2011, the IRS Office of Chief Counsel released a memorandum it had prepared in October 2010 regarding the deductibility of donations that entitle the taxpayer to a state level tax credit.[24] More specifically, the Memorandum considered, *inter alia*, whether a taxpayer's contribution of cash or other property to a state agency should be considered a charitable deduction under section 170 of the Internal Revenue Code ("Code") or payment of a state tax under section 164 of the Code when the taxpayer receives a state income tax credit in lieu of a state charitable contribution deduction for the payment.

The facts considered in the Chief Counsel's analysis can be summarized as follows. Over the course of two years, the taxpayers contributed cash and appreciated property to certain qualifying organizations under the terms of four tax credit programs adopted by State X. Under the law of State X, the tax credits could be used to reduce the taxpayers' state income tax liability in the year of the contribution, carried forward to the following year if unused in the year of the contribution, or sold to other taxpayers who would use the credits to reduce their state income tax liability.

[24] While the memorandum can be viewed as the office's current position on the topic, it bears noting that the views expressed in the advice expressed in the memorandum "may not be used or cited as precedent." Office of Chief Counsel Internal Revenue Service, Memorandum No. 201105010 at 1 (Feb. 4, 2011).

In Year 1, the taxpayer submitted applications to the State Department of Economic Development and was granted a state tax credit equal to an unspecified percentage of the contributions. The taxpayers used a portion of those credits to reduce their Year 1 state tax liability, sold another portion to other taxpayers, and carried forward the remaining credits to future tax years. In Year 2, the taxpayers submitted applications to the State for additional contributions and claimed the resulting state tax credits, as well as the credits carried forward from Year 1, to offset their Year 2 state income tax liability.

The Chief Counsel's analysis of the federal income tax consequences of these contributions is relatively brief and straightforward. It begins with a standard recitation of black letter law concerning charitable contributions. To be deductible as a charitable contribution under section 170, the memo notes, "a transfer to a charitable organization or government unit must be a gift," defined here as "a transfer of money or property without receipt of adequate consideration, made with charitable intent." Moreover, a transfer will not be considered to have been made with charitable intent "if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer." Where the transferor receives some benefit in exchange for the contribution, "the transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift."

An obvious question arising from the principles just described is whether the federal or state tax benefits accruing to a taxpayer as a result of making a charitable gift should be regarded as a "benefit received" that might reduce or eliminate the charitable nature of the transfer. In a series of cases cited in the Chief Counsel's Memorandum, federal courts have generally held that the "tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself."[25] In many of these cases, the court's conclusions are stated in very strong terms. For example, in *McLennan*, the U.S. Claims Court noted that that "a donation of property for the exclusive purpose of receiving a tax deduction does

[25] Citing McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd 994 F.2d 839 (Fed. Cir. 1993); Skripak v. Commissioner, 84 T.C. 285, 319 (1985); Allen v. Commissioner, 92 T.C. 1, 7 (1989), aff'd 925 F.2d 348 (9th Cir. 1991).

not vitiate the charitable nature of the contribution."[26] Likewise, in *Skripak*, the Tax Court stated that "a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution."[27]

The central question addressed in the Chief Counsel's Memorandum is whether a tax *credit* should be treated any differently than a tax *deduction* in assessing whether the taxpayer has received a "benefit" that might reduce or eliminate the federal income tax deduction. Because deductions and credits have essentially identical effects—i.e., reducing the donor's income tax liability by some amount—it is hard to see why one would ignore the tax benefits associated with deductions while taking into account any tax savings arising from tax credits. It is possible that the value of a deduction (which depends on the taxpayer's marginal tax rate) and the value of a tax credit (which depends on the statutory credit percentage) may differ, but there is no reason to assume that either one will be systematically higher or lower than the other.

Perhaps in recognition of the fundamental interchangeability of credits and deductions, the Chief Counsel refused to apply a different rule for tax credits than the one that already applies for tax deductions, concluding that "we see no reason…to distinguish between the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question." This language seems to suggest that the same treatment accorded to a tax deduction where the taxpayer's marginal state income tax rate is 10 percent would also be extended to a situation where the taxpayer claims a state income tax credit, regardless of the statutory credit percentage. Significantly, however, the Memorandum also states that "*[t]here may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability*."

[26] McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd 994 F.2d 839 (Fed. Cir. 1993).
[27] Skripak v. Commissioner, 84 T.C. 285, 319 (1985).

We have italicized this language from the Chief Counsel's Memorandum because we believe it represents a silent recognition of the potential federal tax benefits to AMT taxpayers from claiming especially "generous" state tax credits for charitable contributions. To be sure, these benefits arise from the use of less generous state tax credits, as well as tax deductions. Indeed, any payment that reduces an AMT taxpayer's state income tax liability while increasing her charitable contribution deductions converts non-deductible taxes to deductible gifts to the extent of the reduction in state tax liability. In most cases, however, the magnitude of the federal tax benefit is relatively insignificant. For example, in the case of state charitable contribution deductions the benefit is unlikely to exceed one-tenth of the amount of the gift because state income tax rates only rarely exceed 10 percent.[28]

Where a state income tax credit features a higher credit percentage, the federal tax benefit is correspondingly greater. Again, the benefit to the taxpayer is greatest where the state allows a 100 percent income tax credit, fully compensating the taxpayer for the cost of her "gift." State tax credits featuring a lower percentage are naturally less attractive to the taxpayer, but hold the potential of generating resources for the state.

C. *Transferable Tax Credits under Tempel v. Commissioner*

To this point in the analysis, we have been assuming a program in which the state income tax credit may be utilized only by the taxpayer making the initial contribution giving rise to the credit. It is possible, however, that the state will permit those credits to be sold by the original claimant and transferred to a taxpayer better positioned to make use of the state income tax credit. This was precisely the type of statute that the taxpayers took advantage of in the case of *Tempel v. Commissioner*, a recent decision of

[28] For example, in a state that follows federal law in allowing charitable contribution deductions, a $10,000 gift to charity would, assuming a 10 percent state income tax rate, reduce the donor's state income tax liability by $1,000—in effect shifting $1,000 of non-deductible taxes to $1,000 of deductible donations.

the U.S. Tax Court.[29] The *Tempel* case illustrates a further benefit that might be derived from the adoption of a state charitable tax credit.[30]

In December 2004, Colorado residents George and Georgette Tempel donated certain conservation easements to the Greenlands Reserve, a non-profit organization formed to promote environmental protection and open space through the acquisition of negative easements limiting development on the donated property. In an effort to encourage the transfer of easements to such organizations, Colorado granted donors a state income tax credit equal to (i) 100 percent of the first $100,000 of the value of the easement, plus (ii) 40 percent of the value of the easement in excess of $100,000. In no event could the credit exceed $260,000. These credits could be utilized by the donor to reduce their Colorado state income tax liability (and, under certain circumstances, could generate refunds) or could be transferred, with or without consideration, to other taxpayers who could use the state income tax credits to reduce their Colorado state income tax liability (but not to generate a refund).

Based on a value of the easements of $836,500, the Tempels received state income tax credits of $260,000, the maximum credit allowable under the Colorado statute. It appears that they used most of the credits to reduce their own state income tax liability. Consistent with Chief Counsel Memorandum 201105010, the IRS contended, and the taxpayers agreed, that the Tempels' "receipt of State tax credits as a result of their conservation easement contribution was [not] a quid pro quo transaction." For purposes of its analysis, the Court accepted this position. Because this issue was not in dispute, the Court's acceptance of the parties' stipulation should not be regarded an element of the holding in the case. Nevertheless, the Court's acceptance of the parties' stipulation on this issue, along with its own citation to Memorandum 201105010, reinforces the view that a taxpayer receiving a state charitable tax credit need not reduce the amount of the charitable contribution deduction by the value of the credit.

[29] Tempel v. Commissioner, 136 T.C. No. 15 (2011).
[30] Erik M. Jensen, *The Sale of State Tax Credits: A Tax Court Decision Isn't a* Tempel *of Doom*, 28 Journal of Taxation of Investments 91 (2011); Erik M. Jensen, *The Sale of Tax Credits Revisited: A CCA Consecrates (Most of* Tempel*)*, 29 Journal of Taxation of Investments 59 (2012).

The central issue in the *Tempel* case was the proper federal income tax treatment of the taxpayers' transfer on December 22, 2004 of $40,500 of the state income tax credits for $30,375. The taxpayers took the position that the sale gave rise to long-term capital gain, while the IRS contended that the taxpayers realized ordinary income from the sale. After a lengthy analysis, the Court concluded that the taxpayer had short-term capital gain from the sale of the credits in 2004. It also determined that the taxpayer had a zero basis in the credits, with the result that it experienced a gain of $30,375 from the December 2004 sale.

At first blush, this holding seems to split the difference between the competing positions advanced by the taxpayers and the IRS. After all, short-term capital gain is generally taxed at the same rate as ordinary income, suggesting that while the Court rejected the government's position, the *de facto* result was equivalent to a government victory. Nevertheless, the *Tempel* holding is remarkable because it suggests that if the taxpayers had only held the credits for more than one year they would have recognized long-term capital gain from the sale of the credits. In combination with the Chief Counsel's position that a taxpayer need not reduce her charitable contribution deduction by the value of the state tax benefits generated by the donation, the holding in *Tempel* appears to give donors the ability to convert ordinary income (taxed at a maximum statutory rate of 35 percent) to long-term capital gain (typically taxed at 15 percent).[31]

To illustrate, assume for the sake of analysis that the taxpayers in the *Tempel* case contributed a conservation easement worth $100,000 to Greenlands Reserve. Assume further that, rather than using any of that credit to reduce their own state income tax liability, the Tempels instead sell the full $100,000 worth of credits for $100,000 after the requisite holding period. Taxes aside, they have experienced no increase or decrease in wealth, having parted with property worth $100,000 but receiving $100,000 cash. Note, however, that while the $100,000 "donation" will reduce the Tempels' federal income tax

[31] 26 U.S.C. section 1(a), (h). Even if the taxpayer fails to satisfy the holding period to qualify the gain from a sale of the credits as long-term capital gain, short-term capital gain can be preferable to ordinary income in that it can absorb capital losses without limit (whereas capital losses can only offset ordinary income up to $3,000 per year). Thus, converting ordinary income to short-term capital gain may be beneficial to taxpayers with significant capital loss carryovers from previous years.

liability by as much as $35,000 (i.e., $100,000 multiplied by the top marginal tax rate of 35 percent), the $100,000 gain from the sale of the credits increases their federal income tax liability by only $15,000 (i.e., $100,000 of long-term capital gain multiplied by the maximum rate on net capital gain of 15 percent). In effect, the donation permitted them to convert $100,000 of their ordinary income (via the charitable contribution deduction) to long-term capital gain.

By treating the sale of state charitable tax credits as the sale of a capital asset, while also allowing a full deduction for gifts without reduction for the state tax benefits generated by the contribution, the *Tempel* holding effectively empowers state governments to issue "capital gains coupons"—in the form of transferable state charitable tax credits. This outcome expands the population of taxpayers who could potentially benefit from the adoption of a state charitable tax credit beyond just those taxpayers subject to the AMT. *Any* itemizing taxpayer subject to a marginal tax rate on ordinary income greater than the capital gains tax rate could potentially benefit by making a gift that generates a transferable state charitable tax credit, claiming the full federal deduction for the gift, then later selling the credit at the lower capital gains rate.[32]

To illustrate the effects of this transaction, assume that taxpayer Dan makes a $100,000 donation to a California state agency and in exchange for that gift receives a $100,000 state charitable tax credit, which may be used to reduce his own state income tax liability or may be transferred to a third party for use in satisfying that person's state income tax liability. Under the logic of Chief Counsel Memorandum 201105010, Dan should be entitled to a federal charitable contribution deduction of $100,000, which should have the effect of reducing his federal income tax liability by as much as $35,000 (i.e., $100,000 multiplied by the top marginal rate of 35 percent). If Dan is an itemizing taxpayer not subject to the federal AMT, using the credit to satisfy his own state income tax liability will have the dual effect of (1) increasing his charitable contribution

[32] It is worth noting that while a payment by a purchaser of state tax credits "is clearly not a payment of tax or a payment in lieu of tax" that would be deductible under section 164, the IRS appears to accept as a deductible tax payment the use of the credit as a means of satisfying the credit purchaser's state tax liability, analogizing the use of the credit to a transfer of property by the taxpayer in satisfaction of her tax liability. *See* PLR 200348002 (August 28, 2003).

deduction by $100,000, and (2) reducing his state and local tax deduction by $100,000. In other words, it's a wash for Dan.

However, if Dan *sells* his $100,000 hypothetical California state income tax credit to Boris, he will (1) deduct $100,000 as a charitable contribution deduction under the logic of Memorandum 201105010, and (2) recognize $100,000 of gain from the sale of the credits under *Tempel*. Assuming Dan holds the credits for a year before making the sale to Boris, the $100,000 gain should be taxed as long-term capital gain, most likely subject to the maximum statutory rate of 15 percent. Thus, the net benefit of the transaction is $20,000 to Dan (i.e., $35,000 less $15,000). Meanwhile, Boris should be indifferent to paying $100,000 to Dan or to the State because, according to the IRS, "a purchaser of transferable Credits will be allowed a deduction under § 164 for State X income taxes paid with the purchased Credits."[33]

As with the non-transferable charitable tax credit described above, the State may decide to capture some portion of the tax savings by specifying a credit percentage less than 100 percent. For example, assume that the credit percentage is 90 percent and Dan again makes a donation of $100,000. With the lower credit percentage, Dan will be entitled to a tax credit of $90,000. If he later sells the credits to Boris for $90,000 (after the one year holding period for long-term capital gains), he will (1) deduct $100,000 as a charitable contribution deduction in year 1 (tax savings of $35,000 based on a 35 percent tax rate), and (2) recognize $90,000 of long-term capital gain in year 2 (tax of $13,500 based on a 15 percent rate). Here the net benefit from the federal government is $21,500 but it is divided between Dan ($11,500) and the state government ($10,000).[34]

There are numerous variations on these stylized hypotheticals that could illustrate the effects in slightly different circumstances, involving taxpayers subject to higher or lower marginal tax rates, state credits for taxes other than income taxes, credits that could be

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[33] PLR 200348002 (August 28, 2003).

[34] In effect, Dan has converted $90,000 of ordinary income into long-term capital gain, reducing the tax on that $90,000 of income by 20 percentage points (35% to 15%) for a tax savings of $18,000 and he is also getting the benefit of tax savings at the rate of 35% for the $10,000 "real" gift for a tax savings of $3,500. So Dan parts with $10,000 (net payment to State) but gains $21,500 in federal tax savings for a net benefit to Dan of $11,500 and a net benefit to the State of $10,000.

used by businesses to offset their tax liability, etc… While each of these situations presents slightly different tax implications, the core tax advantage in each case arises from the possibility that a taxpayer who transfers $X to a qualified entity, including a state agency, is entitled to deduct $X as a charitable contribution on her federal return even though she receives a state tax benefit—perhaps even a benefit equal to $X—as a result of making the gift.

IV. California's Proposed Tax Credit for Donations to Cal Grants

To this point in the analysis we have left unspecified the types of public programs that could benefit from a state charitable tax credit program. As noted in Part II, the only requirement of federal law concerning contributions to state agencies is that "the contribution or gift [be] made for exclusively public purposes." Thus, it would appear that states such as California have wide latitude in designing charitable tax credits.

For purposes of illustration, we will consider how such a program might work in the context of public higher education. California State Senator Kevin de León recently introduced legislation to promote charitable contributions to fund an expansion of coverage under the "Cal Grants" program—the state's principal means of providing financial support for low and middle-income students to pursue postsecondary education. The discussion that follows uses the de León legislation as a platform for considering how the state might take advantage of IRS Chief Counsel Memorandum 2011010050, the federal AMT's differential treatment of charitable contributions and state/local taxes, and the Tax Court's decision in *Tempel*.

A. *The Higher Education Investment Tax Credit*

In early 2012, Senator Kevin de León introduced SB 1356, legislation that would have established a new *Higher Education Investment Tax Credit Program Special Fund* ("HEITCP"). The HEITCP is designed to provide new funding for Cal Grants, a state-funded program, as noted above, that provides financial aid to low- and middle-income students to attend college.[35] One rationale underlying SB 1356 is the significant

[35] California Senate Bill 1356 (2012); de León, K., *Backgrounder on SB 1356 – Higher Education Income Tax Credit Fund*, (2012).

reduction in state support for higher education over the past quarter century. A recent analysis suggests that per student funding for public higher education in California has declined by 46 percent during 1990-2012.[36] In absolute dollar terms, California has reduced funding for public post-secondary institutions by $1.4 billion during 2006-2012.[37] SB 1356 appears to be motivated by a desire to temper these effects by increasing funds available for middle-income households hoping to pursue postsecondary education.

The mechanism by which the HEITCP aimed to accomplish this goal is precisely the one we have been describing in this chapter—i.e., a state-level tax credit for taxpayers that make donations to the program. The language of the bill as proposed awarded a 60 percent state tax credit for donations to the HEITCP in calendar year 2013.[38] The tax credit was to be reduced by 10 percent in both 2014 and 2015 after which point the program would end.[39] The program fund was capped at $100 million annually.[40]

Applying the analysis discussed above in Part III, a gift to the HEITCP would generate two significant tax benefits for the donor. First, the taxpayer would be entitled to a state income tax credit in the amount of 60 percent of the amount of the gift (assuming a gift in 2013). Second, applying the logic of Chief Counsel Memorandum 201105010, the taxpayer would be entitled to claim a charitable contribution deduction on her federal income tax return for the full amount of the gift.

To illustrate, assume that Elena makes a qualifying gift to HEITCP of $100,000, which under SB 1356 would entitle her to a California state income tax credit of $60,000. Assuming for the moment that Elena is *not* subject to the federal AMT, this gift should (1) entitle her to a charitable contribution deduction of $100,000 on her federal income

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[36] John Quinterno, *The Great Cost Shift: How Higher Education Cuts Undermine the Future Middle Class* 16 (Demos Public Policy Research, March 2012).
[37] Illinois State University, Grapevine – An annual compilation of data on state fiscal support for higher education, (2012) http://grapevine.illinoisstate.edu/tables/FY12/Revised_March13/Table%201%20Revised.pdf; State Higher Education Executive Officers, State Higher Education Finance FY 2011, http://www.sheeo.org/finance/shef/SHEF_FY11.pdf
[38] California Senate Bill 1356 Sec. 1(a)(1)(A) (2012).
[39] *Id*. at Sec. 1(a)(1)(B) (2012).
[40] *Id*. at Sec. 1(b)(1) (2012).

tax return, and (2) reduce her California state income tax liability by $60,000, which will (3) reduce her federal deduction for state/local taxes by $60,000. The net effect is that Elena's payments to the State of California increase by $40,000 and her overall federal deductions increase by $40,000. For purposes of analysis, we will refer to the $40,000 figure as the "true gift" portion of her total payment to the state and the $60,000 portion as a "faux gift" since it is effectively refunded to her via the state tax credit. Elena's federal income tax burden drops by $14,000, which is simply the $40,000 true gift portion of her donation multiplied by the top rate of 35 percent. Note that this result is no different from the benefit Elena would receive by making a charitable donation of $40,000 to the State of California.

Algebraically, the net after-tax cost of the gift to Elena can be stated as follows:

$$G\,(1-f)(1-s) \tag{1}$$

or

$$G\,(1-f-s+fs) \tag{2}$$

where G is the gross amount of the gift, *f* is the federal marginal tax rate and *s* is the state credit percentage. Assuming a federal rate of 35 percent and applying the HEITCP credit percentage of 60 percent, the after-tax cost of a $100,000 gift is $100,000 x $(1 - .35)(1 - .60)$ or $26,000. Intuitively, this can be described as a combination of the following: (1) a gross cash outflow of **$100,000**, (2) *minus* **$35,000** in federal tax savings from the federal charitable contribution deduction of $100,000, (3) *minus* **$60,000** in state tax savings from the state charitable tax credit at a 60 percent credit percentage (4) *plus* **$21,000** in increased federal taxes arising from the $60,000 reduction in the federal deduction for state/local taxes.

The key thing to note here is that even though Elena is saving $35,000 in federal taxes by virtue of her $100,000 charitable contribution deduction, she is also increasing her federal tax payments by $21,000 by virtue of losing $60,000 in deductions for state and local taxes. In effect, because Elena loses $60,000 worth of California state/local tax deductions on her federal return, she ends up deducting only the "true gift" portion of her

donation. The "faux gift" portion is effectively rendered non-deductible by the $60,000 reduction in the deduction for state and local taxes.

If Elena is subject to the federal AMT, the $100,000 gift to the HEITCP will similarly (1) entitle her to a charitable contribution deduction of $100,000 on her federal income tax return, and (2) reduce her state income tax liability by $60,000. Significantly, however, the reduction in state income tax liability in this scenario has no effect on Elena's state/local tax deduction because state/local taxes are not deductible for AMT taxpayers. The result is that Elena deducts not only the $40,000 "true gift" portion of her donation (saving her $11,200 in federal income taxes) but also the $60,000 "faux gift" portion (saving her $16,800 in federal income taxes). As a result, her total federal tax savings will be $28,000—i.e., $100,000 gross gift multiplied by a marginal tax rate of 28 percent (i.e., the top rate for AMT taxpayers).

Algebraically, the net after-tax cost of the gift to Elena when subject to the AMT can be stated as follows:

$$(3) \qquad G\,(1 - f - s)$$

which differs from equation (2) above only in that it does not feature the "$+fs$" term that represents the federal tax increase attributable to the loss of state and local tax deductions that an itemizing taxpayer would normally experience as a consequence of a reduced state income tax burden. But recall that in the non-AMT example it was the loss of state/local deductions that effectively rendered the "faux gift" portion of the donation non-deductible. Because an AMT taxpayer has no state/local tax deductions to lose, there is no mechanism by which her federal deductions are effectively limited to the "true gift" portion of the donation.

Based on the analysis just presented, we can see that an AMT taxpayer making a $100,000 donation to the HEITC special fund has a net out-of-pocket cost of only $12,000—i.e., $100,000 minus $28,000 (in federal tax savings) minus $60,000 (in state tax savings). Clearly the tax savings for this type of donation are well in excess of the tax savings normally arising from charitable gifts. AMT taxpayers willing to make a gross

gift of one dollar to Cal Grants will be reimbursed a total of 88 cents, consisting of 60 cents from the State of California and 28 cents from the federal governments.

As currently structured, SB 1356 is a powerful "matching grant" program that, if enacted, is likely to generate significant new funds for the Cal Grants program. Indeed, the matching rates are so generous that it is also likely to draw charitable dollars away from other worthy causes. Even so, it is worth noting that the program could be made even more attractive to potential donors. The most obvious way of doing this would be to increase the credit percentage. Any credit percentage greater than 72 percent would ensure that donors experience no out-of-pocket cost for their donations. In states with charitable tax credit programs already in place, tax planners are beginning to catch on. One website describing Arizona's tax credit for school tuition organizations notes that "if you are subject to the Alternative Minimum Tax (AMT), … the tax benefits received exceed the out-of-pocket cost."[41]

B. *Expanding the (Potential) Benefits of SB 1356*

The two examples just described—one involving an itemizing taxpayer not subject to the AMT and the other featuring a taxpayer subject to the AMT—reveal that a state income tax credit of the sort incorporated in SB 1356 is likely to be most attractive to taxpayers subject to the AMT, which includes roughly 750,000 federal tax returns filed from California in 2010. Yet the potential benefit of a HEITC program need not be limited to AMT taxpayers. Building from the analysis in Part III, we note two possible changes to the HEITC framework that could expand the reach of its benefits.

First, to the extent that the tax credit is transferable, the Tax Court's recent decision in the *Tempel* decision discussed above suggests that a sale of the credit will give rise to capital gains rather than ordinary income. As a result, a taxpayer not subject to the AMT would actually be better off selling the credit (after holding it for more than a year to qualify for long-term capital gains) instead of using it herself. As noted above, using the credit results in a lower federal deduction for state and local taxes—i.e., the "$+fs$" term

[41] George Woodard, *Expansion of Private School Tuition Tax Credit Program* (May 8, 2012) http://www.hhcpa.com/blogs/income-tax-accountants-cpa/expansion-of-private-school-tuition-organization-tax-credit-program).

in equation (2). By selling the credit after a year, the taxpayer experiences a different and smaller federal tax increase (this can be portrayed by replacing the "$+fs$" term in equation (2) with "$+ks$" where k is the federal capital gains rate) than if she uses the credit herself.

As an example, assume that Peter donates $100,000 to the HEITC fund, which entitles him to a $60,000 credit that he sells 13 months later for $58,000. Under the logic of 201105010, he should be able to claim a deduction of $100,000 for the donation, which assuming a federal tax rate of 35 percent saves him $35,000 in federal income taxes. The subsequent sale of the credit for $58,000 (zero basis) generates a tax of $8,700 ($58,000 x 15%). Thus, while Peter experiences an initial cash outlay of $100,000, he recoups $84,300 from federal tax savings and the later sale of the credits to a third party.

Second, the benefit of the HEITC program could be expanded by providing a credit against taxes *other than* the state income tax. For example, if the state were to grant a 60 percent sales tax credit instead of an income tax credit, such a program would likely be attractive not only to AMT taxpayers but also (and even more so) attractive to high-bracket itemizing taxpayers not subject to the AMT. This is because sales taxes are generally not deductible for purposes of the federal income tax.

For example, if Lakshmi were to donate $100,000 and as a result qualify for a $60,000 sales tax credit, she would (1) be able to claim a $100,000 charitable contribution deduction under the logic of CCA 201105010, and (2) reduce her state sales tax payments by $60,000. Although sales tax credits are far less common than income tax credits, they are not unheard of. Perhaps the sales tax credit could take the form of a debit card that the taxpayer could use to make sales tax payments when making taxable purchases.

Lakshmi's reduction in state sales tax liability should have no effect on her federal income tax liability as sales taxes are generally not deductible. But note that she is effectively making sales taxes deductible by smuggling them into her $100,000 charitable contribution deduction. As a result of her $100,000 "gift," Lakshmi's federal income tax burden should be reduced by $35,000 (assuming a 35 percent federal tax rate). In form,

Lakshmi is donating $100,000 to a good cause. In substance, one might say that she is (1) donating $40,000 to a good cause, and (2) purchasing a $60,000 prepaid sales tax debit card. Because of Memorandum 201105010, *both* of these amounts appears as deductions on her federal income tax return in the form of a $100,000 charitable gift, saving her $35,000 in federal income taxes.

Of course, as with our other examples, the benefit can be made even more generous by increasing the credit percentage. For example, if we assume a state sales tax credit of 75 percent for donations to a state agency, anyone subject to a federal marginal tax rate greater than 25 percent, whether subject to the AMT or not, would actually profit by making a "gift" to the state agency. We hasten to emphasize that this "profit" comes at the expense of the federal Treasury and thus has more in common with the gains enjoyed by Bonnie and Clyde than a small business owner or productive entrepreneur. Still, given the IRS position in CCA 201105010, it is understandable why a state may wish to partner with its taxpayers to promote charitable gifts to state agencies.

V. Conclusion

As we have noted, the opportunities for California to make its tax code more "efficient" from a state perspective might well be considered bad policy from a national viewpoint. If we were advising Congress, we might well suggest that these opportunities result from flaws at the national level. However, members of the state legislature are custodians of *state* welfare, particularly in an era of state budgetary distress. Thus, it behooves the legislature at least to investigate potential adjustments to California state tax arrangements that would benefit the state by bringing in more federal dollars.

CHAPTER 3

Historic Preservation: A Policy Option in California

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Historic preservation is a way to embrace California's unique development and serves as a vital educational tool for future generations. Often overlooked, historic preservation is also an important tool for economic development and the revitalization of distressed communities. It provides an alternative to costly demolition and large-scale development. And it creates jobs, keeps money within communities, and allows for the conversion of historic buildings into affordable housing units.

Nevertheless, state policymakers have not actively promoted historic preservation as a tool for economic development and community revitalization. In this chapter, I suggest that the state renew its efforts in historic preservation programs as an additional mode of recovery during hard economic times. I argue in favor of historic preservation by discussing associated financial and economic benefits and incentives conclude with recommendations for future historic preservation efforts.

California and Historic Preservation: Initial Development

Rich in open space and natural resources, early 20th-century California focused much time and decision-making on land and environment conservation. By 1976, historic preservation was officially included in a comprehensive statewide plan with aims to protect and preserve structures of historical significance. However, the state's interest in historic preservation developed in stages.

In the 1940s, the conservation of natural resources for recreational and educational use was the primary interest of the state. Two significant events of that decade included the approval of a centennial celebration of the California gold discovery and gold rush and the passage of the Omnibus Park Acquisition Act (1945) for the creation of statewide recreational facilities.[1] An Historical Landmarks Advisory Committee was appointed in 1949, but historic preservation was overseen by the Division of Parks and Beaches and the conservation of natural resources prevailed over historic preservation.[2]

By 1951, a "history section" was added to the Division of Parks and Beaches as an effort to shift some focus to historic preservation. This addition spurred greater interest in preservation as evidenced by the allocation of nearly $2 million for the restoration of historic buildings

between 1952 and 1957.[3] In the early 1960s, the history section became a "history program," establishing guidelines for historic landmarks, application processes, and evaluation procedures.[4] The national urban renewal movement to save cities from blight triggered a subsequent movement to preserve historic landmarks threatened by renewal programs.[5] These movements had a profound impact on California's preservation efforts. By 1965, it seemed that the state was ready to increase its involvement in preserving and protecting historically significant structures.

The National Historic Preservation Act of 1966 changed the nature of historic preservation in the U.S. and California. This legislation sought to support historic preservation programs at the federal and state levels and to protect historic properties. The federal government would have a substantial role in preservation by connecting with governments, public and private agencies, and organizations to promote historic preservation.[6] A National Register was created, a grants program was set up, and an Advisory Council was established as a consequence of the 1966 Act.

California responded by reorganizing its state-level preservation efforts. An historian, architect, and archaeologist were added to the Historical Landmarks Advisory Committee. The history program became the "History Preservation Section" with a focus on non-park system preservation projects.[7] A three-volume comprehensive preservation program was created that included yearly plans for preservation grants, an inventory system for historic sites and buildings, and an overall plan for implementing historic preservation in the state.[8] The Office of Historic Preservation (OHP) was the most important element to come out of the new push for historic preservation.

The Office of Historic Preservation Today

OHP has evolved since its creation as the key state governmental agency in charge of implementing federal and state historic preservation programs.[9] It handles state and federal components of preservation programs to ensure that California continues to have an environment conducive to protecting and preserving its cultural and historical identity. Today OHP is headed by the State Historic Preservation Officer (SHPO) who oversees various state programs for historic preservation that provide survey, grant, and regulatory services for municipalities.[10]

The primary purpose of OHP, as the main governmental agency in charge of federal and state historic preservation programs, is to encourage and promote historic preservation as well as to provide assistance to local jurisdictions and agencies partaking in conservation. Additionally, OHP recognizes economic revitalization as a fundamental component of historic preservation.[11] Despite these features of OHP, the State of California continues to be disengaged with historic preservation—a disengagement which may be caused by high costs of preservation and the lack of awareness of financial and economic incentives available to offset the costs.

OHP receives its funding annually through grants from the Historic Preservation Fund (HPF), created in 1966 by the National Historic Preservation Act. Each year, headed by the National Park Service and the U.S. Department of Labor, the HPF is funded by outer continental shelf oil lease revenues. Federal funding for OHP is then matched by the State of California.

Aside from implementing and overseeing preservation programs, OHP is overseen by the State Historical Resources Commission (SHRC) staff. The SHRC is a state review board that is appointed by the governor. As a review board, this commission has the responsibility to review nominations to the registration programs that are administered by OHP. There are currently four state and federal registration programs within OHP's jurisdiction: the National Register of Historic Places, the California Register of Historic Places, the California Historical Landmarks, and the California Points of Historical Interest.

California's Historic Resources

As part of its preservation efforts, California established designations for various buildings and sites that have historic values. *California Historical Landmarks* are building sites, features, or events of statewide historic significance.[12] The Los Angeles Memorial Coliseum is an example of a California Historical Landmark due to the various sports, political, and historical events that have been held in the stadium. *California Points of Historical Interest* are sites similar to California Historical Landmarks, but are of either city or county historical significance and value. The oldest standing Bob's Big Boy Restaurant in Burbank, California is an example.

California Register of Historic Resources are buildings, sites, structures, objects and districts that are significant to state values. The Watts Towers in Los Angeles, California is an

example. Finally, *National Register of Historic Places* are buildings, sites, structures, objects, and districts with local, state, or national historical significance in American history. The Golden Gate Bridge in San Francisco is an example of a structure found on the National Register of Historic Places.

The Case in Favor of Historic Preservation

The preservation of historic buildings can be costly, oftentimes discouraging property owners from carrying out rehabilitation projects. Many property owners would demolish their historic buildings or have developers redevelop historic sites absent alternative incentives. However, there are economic and financial incentives available for preserving a historic building or landmark that can avert such destruction at both the national and state levels.

National Financial Incentives for Historic Preservation

The *Federal Historic Preservation Tax Incentives Program* offers two tax-saving opportunities, a 10% or 20% tax credit, for the rehabilitation of historic and non-historic buildings of national, state, and local significance.[13] To be eligible for this program, historic buildings must be rehabilitated as income-producing properties, thus offsetting the potential money lost in repair. This program is considered to be a very effective federal program for rehabilitation because of its potential to create private investment in preserving historic buildings. In 2011, it was estimated that since 1976, rehabilitation projects supported by tax credits involved a total of $90.4 billion in private investment nationally.[14]

The 20% tax credit allows for the rehabilitation of historic buildings that are classified as "certified historic structures" by the National Park Service.[15] A certified historic structure is defined as "any building and its structural components that is listed in the National Register of Historic Places or located in a registered historic district."[16] There is an application and inspection process to obtain the tax credit. Once it is approved, the rehabilitation of the building must adhere to specific standards. The Internal Revenue Service (IRS) administers the procedures under which a 20 percent tax credit may be taken based on the rehabilitation

expenses.[17] Around a thousand such projects are approved each year, involving more than $4 billion in private investment.[18]

The 10% tax credit allows for the rehabilitation of non-historic buildings constructed before 1936. A major restriction on the rehabilitation of these buildings is that the finished product cannot be intended for residential-use. There are fewer overall guidelines and rehabilitated buildings are not required to go through an elaborate review process.

In California, the cities that utilize federal tax credits most include Los Angeles, San Francisco, and San Diego. California ranks eighth in the country for total private investments generated from preservation projects. Such projects have included rental housing, conversion of commercial space into housing, hotel use, and retail.

The *Preserve America Grant Program* rewards communities that incorporate their heritage into economic development and community revitalization. To be a certified Preserve America location, communities can hold activities that promote historic preservation such as – but not limited to – historical landmark tours or community-wide events in recognition of key historic areas. Preserve America certified communities are eligible to receive grants for maintenance of historic sites and for funding historical activities. A typical federal budget allocation for Preserve America grants is about $7.5 million.[19]

California has 26 certified Preserve America communities, which include two counties and five neighborhoods (e.g., Thai Town and Little Tokyo in Los Angeles).[20] As an example, Santa Monica received a Preserve America grant of $100,000 to fund "100 Years in the Past, 100 Years in the Future" – a yearlong campaign in 2009 to celebrate the cultural and historical value of the Santa Monica Pier.[21] Preserve America grants allow California communities a chance to develop resource management skills and become "self-sustaining" entities capable of promoting culture while improving their economic situations.[22]

Incentives at the State Level

The rehabilitation process for historic buildings requires the structure to meet code requirements. Bringing a structure up to code may be a difficult task since these buildings are

historic and may not have been built to modern standards. The *California Historic Building Code* (CHBC) provides a set of alternative building regulations for historic buildings that permit various repairs and additions necessary for the preservation or rehabilitation project.[23] Additionally, the historic structure undergoing preservation or rehabilitation does not need to be a certified National Register Historic Place, State Historic Landmark, or a Point of Interest; it just needs to be of historical importance as determined by local or state government. The CHBC encourages preservation projects that are environmentally friendly, conserve energy, and use a cost effective approach to redevelopment.

The *Certified Local Government Program* (CLG) provides an opportunity for designated local governments to enter into a partnership with the Office of Historic Preservation and the National Historic Preservation Program.[24] This program was created in 1980 under an amendment to the National Historic Preservation Act with the purpose of "institutionalizing" and "legitimizing" historic preservation as a function of national, state, and local governments.[25] By becoming CLGs, local governments may be able to receive grants to help fund preservation projects such as surveys, commissions, guidelines, tourism programs, and planning. The National Park Service also offers technical advice to CLGs, which helps streamline preservation projects to get them completed in a timely manner. California is required to "sub-grant" at least 10 percent of its yearly allocation of federal funds from the Historic Preservation Fund Grants Program to its CLGs.[26] Among all the states, California receives the largest allocation of federal funds and has 52 CLGs.[27]

In 2011, the state received 15 grant applications and selected 10 CLGs to receive grants for preservation programs.[28] As an example, the City of Los Angeles received a small grant of $22,500 for SurveyLA's "Participation and Outreach Implementation" program in areas including Venice, Westwood, and Wilshire.[29] The CLG program incentivizes historic preservation programs by increasing the likelihood that local governments will receive state and federal grants to complete projects. Such projects ultimately allow the opportunity for distressed localities to provide more jobs and thus spur economic development and recovery.

The *California Main Street Program* (CMSP) dates back to 1986 when California joined the national Main Street Program aiming to promote the revitalization of downtown areas. From 1986 to 2002, this program was run by the California Technology, Trade, and Commerce

Agency and funded through the state's general fund. However, in 2002, the state program was terminated due the state's budget problems of that period. In 2004, a Senate bill reinstated the CMSP on the condition that it would no longer receive funds from the state or be staffed within OHP.

Today, California Main Street projects are privately funded. There are 38 member cities with a waitlist of many others hoping to join the CMSP. Both large and small cities have enjoyed the positive economic impact of CMSP, including cities such as Oakland and Hanford. This program is effective in promoting downtown revitalization through historic preservation and its projects have positively affected distressed communities.

The *California's Mills Act Property Tax Abatement Program* provides an incentive for the historic preservation of buildings. Enacted in 1972, the Mills Act is often seen as the "single most important" incentive for the preservation of buildings in California.[30] The main component of the Act is a contract between local governments and property owners of historically significant buildings in which property owners agree to a 10-year minimum term to "restore, maintain, and protect" the historical building. Local governments also have the freedom to create programs that promote preservation in distinct communities or neighborhoods, thereby contributing to the overall revitalization of their communities.[31] The main incentive for property owners to enter into these contracts is the potential receipt of property tax relief between 40 and 60 percent annually.[32]

In 2011, Assembly Bill 654 was enacted and required that historic properties be inspected before property owners could enter into agreements and that the properties be inspected every five years.[33] This legislation was intended to have affected property assessed accurately, provide a greater role for county officials in making assessments, and reduce the amount of tax money lost from inaccurate appraisals. The Mills Act remains a viable tool for local governments to promote preservation because the abatement of property tax allows property owners to continually fund the maintenance of their historical property each year. There are particularly active Mills Act programs in San Diego, Los Angeles, and Orange counties but fewer than 90 cities and counties throughout California provide a tax abatement program for historic preservation.

Economic Effects of Historic Preservation

Historic preservation is a potential job generator. Historic buildings are considered to be "natural incubators" for small businesses. Some historic conservation economists argue that small business start-ups have an affinity for historic buildings because these businesses cannot afford the rents in modern industrial parks.[34] Historic preservation projects also positively influence surrounding communities by creating jobs and increasing income levels.

Preservation projects are generally more labor intensive than new developments.[35] This characteristic is beneficial to communities because labor services come from local workers such as electricians, contractors, and plumbers who, in turn, spend their paychecks locally, thus stimulating the immediate economy. In comparison, new development is less labor intensive and a greater proportion of the investment goes toward purchasing building materials and equipment from distant areas.

Completed preservation projects are prime examples of adaptive reuse that converts a space into an income-producing entity such as new retail or service-industry businesses. In the end, preservation projects may attract more people to the restored areas. For example, the revitalization of downtown Los Angeles has resulted in a dramatic increase of residents.[36] Revitalizing city cores attracts businesses and more money is thereby spent locally because of the increase of both visitors and businesses. Highly-skilled workers are needed for preservation projects and many of the projects result in service-industry type jobs with good wages. Thus, preservation projects are an environmentally friendly tool for increasing economic development within a distressed community and have the potential to provide increased tax revenue.

Affordable Housing and Historic Preservation

Homeownership is an important way to build wealth, stabilize neighborhoods, and revitalize cities.[37] One pressing issue today is homeownership for low- and moderate-income households. Often, affordable housing is built on the fringes of cities, away from jobs, education, and public transportation. This is an inequitable situation that hinders social mobility and indirectly accelerates the economic decline of city cores. Preservation is one way of addressing homeownership and affordability issues in California.

Older, historic inner-city neighborhoods built prior to 1950 are home to about a third of households with incomes below the poverty line.[38] Thus, there is an incentive for policy makers to encourage restoration of historic homes because such homes may be seen as a form of affordable housing. Through restoration and preservation of historic homes, low- and moderate-income families can utilize centrally located affordable housing rather than live on the fringes of cities far away from job centers and public transportation.

The Los Angeles Example

Given state and local budget problems in California, policy makers are likely to be slow to push historic preservation as a tool for economic development and community revitalization. However, even in hard times there is potential for historic preservation to be utilized as an income-producing policy. The city of Los Angeles provides an example.

The Los Angeles Conservancy is the largest local historic preservation organization in the nation. In 2003 and 2008, the conservancy conducted assessments of preservation efforts of local governments within the county of Los Angeles and issued letter grades. Between 2003 and 2008, the city of Los Angeles raised its grade from a B+ to an A- and continues to make improvements that transform the city into a model for historic preservation in California.

In 2006, the city created an Office of Historic Resources to administer preservation programs in conjunction with the Department of City Planning and the Cultural Heritage Commission. The Cultural Heritage Commission has designated more than 930 historic-cultural monuments (i.e., local landmarks) since the enactment of the Cultural Heritage Ordinance in 1962. For the first time since its enactment, the Cultural Heritage Ordinance was revised in 2007 to allow the City to prevent demolition of cultural and historical resources within the city's historic districts.

Historic districts in Los Angeles are known as Historic Preservation Overlay Zones (HPOZs). These are important for protecting and preserving historic resources. Within the city's 29 HPOZs, the structures are of similar style, the exteriors cannot be changed, and the city has the power to deny demolition.[39] Additionally, in 2007, Los Angeles became a Certified Local Government and received two grants to conduct SurveyLA, its first citywide survey of

historic resources. Los Angeles has the second largest Mills Act program in the state with more than 380 contracts, and the city continues to enter into contracts to promote preservation.[40]

The National Trust for Historic Preservation deems Los Angeles' Adaptive Reuse Ordinance a model policy for the nation. This ordinance relaxes zoning and building code requirements to enable the conversion of "underutilized older and historic commercial and industrial" structures into residential units.[41] During 2000-2011, Los Angeles created more than 10,000 apartment units, saved 60 buildings that would have been demolished, and stimulated $6 billion in economic investment downtown.[42]

Policy Recommendation #1: A Statewide Survey

There exists no research on the collective economic benefits of historic preservation projects in California because the state has not yet conducted a statewide study. OHP should work to develop and publish a detailed assessment of preservation projects throughout the state in order to encourage policymakers to promote historic preservation as a tool for economic development and community revitalization. Many proponents of historic preservation in California use data collected from other states such as Texas and Missouri, as well as large municipalities in California, to show the positive impact of historic preservation projects. Conducting a California-based statewide study would provide the means necessary to push historic preservation as a viable economic tool.

Policy Recommendation #2: Promotion of Partnerships

Other than the Certified Local Government grant program, OHP plays a limited role in financing historic preservation projects. California is one of the few states without its own historic tax credit program; the states with tax credit programs have participative and engaged governments that have completed noteworthy statewide preservation projects. As an alternative to enacting a state historic tax credit program, OHP should consider entering into partnerships with established planning efforts in California that receive federal funding, in order to promote and finance statewide preservation projects.

One potential partnership for OHP is with the state's housing finance agency to promote investment tax credits for low-income housing projects statewide. The housing finance agency

receives funding through the federal Tax Credit Assistance Program (TCAP), a program that provides funding for investment in federal Low Income Tax Credit (LIHTC) projects. The California Tax Credit Allocation Committee (CTCAC), within the housing finance agency, administers its own low income tax credit program to enhance the LIHTC and help state projects receive federal funding. In 2011, California received more than $325 million from TCAP and had $124 million available in state credits to fund low-income housing projects.[43] Through a partnership, OHP could promote the adaptive reuse of historic buildings and conversion into affordable housing units.

Policy Recommendation #3: Encourage Heritage Tourism

The preservation of historically significant structures can enhance the development of heritage tourism in California. Such tourism would produce more state and local tax revenue, spur economic growth, and add to the state's already-successful general tourism industry. California is already the number one destination for tourists in the U.S. By one estimate, tourists in California spend $95.1 billion annually, generating $6.1 billion in state and local tax revenues, and supporting more than 800,000 jobs each year.[44] OHP can promote statewide historic preservation by launching a heritage campaign with tools and resources available for local governments to partake in preservation projects that will ultimately attract more tourists to different areas of the state. One way to launch a campaign is by forming a state cultural commission that designates cultural landmarks and designates regional heritage areas. These regional heritage areas can be collaborative efforts to protect landscape, preserve historical structures, and overall stimulate regional economic development through regional heritage tourism.

Policy Recommendation #4: Encourage Local Ordinances and Conservancies

Historic preservation ordinances allow for greater local government access to federal and state funding because they demonstrate willingness to promote, and commitment to, historic preservation. In California, 250 local governments have historic preservation ordinances. A majority of these local governments have not updated or revised their ordinances since inception. OHP should require the revision of local ordinances to include certain provisions: the designation of historic districts with the authority to deny demolitions, the establishment of a

cultural commission to recognize cultural landmarks, and a stated commitment to capitalize on adaptive reuse opportunities to convert structures into housing or income-producing units. Strong local ordinances are vital for historic preservation to stimulate private investment and economic growth effectively.

OHP should encourage the formation of regional conservancies throughout the state. There are currently two regional conservancies and eight local conservancies. Regional conservancies provide an opportunity to advocate regional issues and educate members of regional communities about the tools and resources available for preservation projects. Additionally, with the demise of community redevelopment agencies in 2012, forming regional conservancies may be an effective way to transfer historic preservation responsibility without overburdening local governments with new responsibilities.

Conclusion

Since the beginning of the 1970s, when California grew more serious about the preservation of historic buildings and structures, the state has benefitted from historic preservation projects. Following the 1970s, financial incentives for preservation have stimulated economic growth and development in California. Today, a growing number of local governments in California recognize and utilize historic preservation as a development tool. At the state level, however, policymakers have not pushed for an active state-sponsored historic preservation program.

The Office of Historic Preservation should conduct a statewide study on the economic impact of historic preservation, explore partnerships with established planning efforts that receive federal funding, promote heritage tourism and the creation of a state cultural commission, and encourage local governments to update their local ordinances in order to create an environment more conducive to preservation projects. Overall, preservation serves as an additional economic tool to utilize during hard economic times and simultaneously allows for continued protection of California's unique history for generations to come.

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CHAPTER 4

Suck it In: Round Two on the California Budget in Jerry Brown's Second Round as Governor

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"Suck it in; vote for the tax."

Governor Jerry Brown's 2012 advice for voters[1]

The California budget saga has no beginning and no end. Each budget is in large part the product of prior budget decisions and earlier events. Once a budget is signed, its story does not end. A budget is a plan and a forecast of revenues and expenditures. However, plans may not work out; forecasts may prove inaccurate. But whatever happens, the current budget will influence budgets to come.

In prior editions of *California Policy Options*, our annual chapters on the state budget have traced current events and past historical developments that either led to those events or which illuminated what was happening with similarities and contrasts with the past. Below, I provide some background to the passage of the 2012-13 budget, the second budget passed during Jerry Brown's current iteration as governor. A critical part of that budget involves passage (or rejection) by voters of a tax initiative sponsored by the governor for the November 2012 ballot. Readers will know the results of that election but this chapter ends with the completion of the legislative session in the late-summer of 2012 and thus was written before voters had their say.

Deep Background: The Golden State Moves Beyond its Golden Era

"Those who have not undergone minor disasters are usually being held in reserve for something major."

Author Gore Vidal[2]

Although it may seem difficult to imagine from today's perspective, in the 1950s and 1960s, California was often seen as a model of state governance and achievement. Cars flowed freely on its newly-built freeways. New college campuses were under construction providing, along with the older ones, higher education at very low cost to California's students. Water traveled long distances on aqueducts considered to be engineering and political marvels. Of course, there were also troubles in paradise. Most prominently in the mid-1960s, there were racial tensions which exploded in the Watts Riots and the student anti-war demonstrations at Berkeley. But racial tensions were hardly unique to California during that era of southern

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[1] Quoted in David Siders, "Jerry Brown Says Tax Signatures in Hand," *Capitol Alert* blog of the *Sacramento Bee*, May 3, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/05/jerry-brown-says-tax-signatures-in-hand.html. The history in this chapter draws heavily from major news sources such as the *Sacramento Bee*, the *Los Angeles Times*, and the *San Francisco Chronicle*. Most footnotes from such sources included in this chapter refer to direct quotes.

[2] Quoted in California's Capitol's website at http://www.californiascapitol.com/calcap/2012/08/too-often-too-true/.

desegregation and civil rights legislation. And student unrest during the Vietnam War era quickly spread beyond California.

By the 1990s, however, the negatives of California seemed to outweigh the positives in comparison to other states. California was mired in a fiscal crisis in the early part of that decade. Civil disturbances were back – this time in the form of the Los Angeles Riots. The freeways were still operating but the era of their wholesale expansion was over and traffic congestion was becoming the norm. Promises of nearly-free tuition at the state's public universities were distant memories.

Attempts at quick fixes by voters for these disappointments did not pan out as anticipated. Incumbent Governor Gray Davis was replaced during a budget crisis via recall in 2003 by movie star Arnold Schwarzenegger. But Schwarzenegger left office in January 2011 during a renewed budget crisis. By then, he was equally as unpopular as Davis had been at the time of the recall.[3] The idea that voters could provide quick remedies through direct democracy was tarnished but not gone. Indeed, new voter-approved changes in legislative redistricting and the implementation of a "top-two" primary system were the reforms *de jour* playing out in the background of California's budget process. More budget-related reforms were placed on the November 2012 ballot, the same ballot that would decide voters' preferences regarding new taxes including those favored by Governor Brown.

How did these turns of events occur? Why did the state develop what is often called a "structural" budget deficit which even periods of prosperity don't seem to erase? The easy answer is to look at the political institutions of the state, particularly California's above-mentioned "direct democracy" of ballot propositions which limit fiscal discretion by the legislature. But such political institutions cannot be the whole story since the state had direct democracy during its golden years when it was viewed as a model of good governance.

There is a deeper cause. As Chart 1 shows, California's population (and economy) generally grew more rapidly than the U.S. as a whole from statehood in the mid 19th century until the first decade of the 21st century. But within that long period, as can be seen on the chart, there are two prominent inflection points. There was particularly rapid growth starting around 1940

[3] Governor Schwarzenegger's unpopularity was increased around the time he left office by a last-minute reduction in a prison sentence he gave to the son of a former speaker of the assembly who had been convicted of murder. In addition, it was revealed that he had fathered a child by a housekeeper who remained in the Schwarzenegger household, a revelation that led to divorce proceedings. Schwarzenegger generally remained out of the policy limelight initially, resuming his movie career and later opening a museum in Austria dedicated to his accomplishments. In the summer of 2012, a public policy institute at USC was opened in his name but Schwarzenegger generally stayed out of discussions of the California budget unlike his predecessor, Gray Davis. Davis regularly appeared on TV news programs and in other forums during the terms of his successors commenting particularly on general budget issues. To the extent that Schwarzenegger commented on California concerns, his remarks emphasized his record on environmental matters which he saw as a legacy and he complimented Governor Brown for pursuing his environmental agenda.

and ending in 1990. That five-decade period encompassed the massive military spending that accompanied World War II and then the Cold War, punctuated by the Korean War and the Vietnam War. During that era, federal expenditures developed and promoted what became the California aerospace industry and other military-related sectors and activities.

In 1990, with the dissolution of the Soviet Union, the Cold War ended and the aerospace and related industries shrank to a fraction of their former importance in California. While the rest of the U.S. had a very mild recession in 1990-91, California experienced an extended decline and a multi-year state budget crisis. There were warnings of a structural deficit in the mid-1990s but the problem was soon masked by the dot-com boom. A new crisis merged with the subsequent dot-com bust. But a second mask appeared with the housing and mortgage bubble that began to burst in 2006 and 2007 and that developed into the financial crisis of 2008 and the Great Recession. Nonetheless, there was evidence of denial among state officials; the state's Department of Finance's estimate of the 2010 California population was overstated by well over a million persons until the federal Census of Population came along with the definitive figures.

Chart 1 also contains a long-term projection of future trends in California. The rapid growth relative to the rest of the U.S. is gone in that projection. California at best becomes an average state growing at the average U.S. rate. And while being average might not seem to be a terrible fate, it appears that voter expectations for the state are still stuck in the era of super-normal growth when there was always money for infrastructure and social programs and a dollar for X did not require a dollar less of Y. The gap between expectations and reality is an underlying cause of the California malaise. If California had always been average, it might have adjusted better to the three post-1990 economic downturns than it actually did.

The shift to a "new normal" after 1990s can also be seen on Chart 2 in terms of jobs. As California departed from its old trend line, the job gap between reality and projection grew. Not surprisingly, the widening job gap, particularly in periods of high unemployment, has become a political issue beyond its obvious budgetary implications. But as far as the state budget goes, fewer workers and taxpayers cuts into revenue in obvious ways.

Is California a particularly high-tax state as a result of the new normal? Chart 3 compares state and local taxes in California against those in other large states and for the U.S. as a whole. State and local taxes have to be combined in such a comparison because each state divides the responsibility for state and local services between the two levels of government differently. California is not a low tax state but it is not at the top, either. It tends to be below average at the local level since Proposition 13 of 1978 restricts local property taxes and makes public services at that level, particularly schools, dependent on state finance. The state government, therefore, shows up as higher-than-average in taxation.

Ultimately, you cannot say that "the" problem in California at the aggregate level is spending or taxes. The problem is a combination of the latter relative to the former. California's political processes – which ultimately reflect, even if imperfectly – voter "tastes," produce more spending chronically than its tax base supports.

Budgetary History

"This is an era of limits and we had all better get used to it."

Jerry Brown in 1976 during his first iteration as governor[4]

As noted at the outset, there is no one place to start in California's budgetary history since each budget reflects prior decisions and results. It is useful, however, since Jerry Brown has had two episodes as governor, to begin descriptively in his first. Brown was the son of former Governor Pat Brown (1959-67) who is now mostly remembered for his freeways, water works, and university expansions. However, when he sought a third term in office in 1966, Pat Brown was defeated by Ronald Reagan in part because of public anger over a budget crisis that developed toward the end of his second term. Voters also blamed him to some degree for the Watts Riots and the student demonstrations at Berkeley.[5] Jerry Brown, as his early political career developed – and although he was a Democrat like his father – seemed to want to be the anti-Pat, i.e., a fiscal conservative with no taste for grand infrastructure projects and with a strong stance against disorder.

Although not a former movie star like Ronald Reagan (or the later Arnold Schwarzenegger), the younger Brown became a national celebrity through politics in his first iteration as governor (1975-83). He was noted for New Age attitudes and being "different" from typical political figures of that era. And he managed both to have an austere personal lifestyle, driving a Plymouth rather than some gubernatorial limo, while also traveling with singer Linda Ronstadt.

In his first term, however, Brown seemed not to detect growing public anger about rising property taxes, a reflection of both general inflation and a state housing bubble. Neglect and then late recognition of the anger culminated with Prop 13, an initiative placed on the state ballot of June 1978 which passed overwhelmingly. Prop 13 drastically cut local property taxes, especially cutting into school budgets, and imposed a two-thirds vote requirement for tax

[4] Quoted on the Alternative History forum at http://www.alternatehistory.com/discussion/showthread.php?p=2501045 and other websites. Although the quote is well known, none of the sources provide a date and location.

[5] At the time Pat Brown ran for a third term, there were no term limits. However, only one prior governor – Earl Warren – had been elected three times (and Warren left before his third term ended to become Chief Justice of the U.S. Supreme Court).

increases.[6] One of the aggravating factors behind the ultimate success of 13 was an accumulation of a large reserve at the state budget level under fiscally conservative Brown.

Despite his late opposition to Prop 13 before it passed, Brown flipped and promised to make 13 work, essentially by bailing out localities with the large state reserve (until it was exhausted) and by spending cuts at the state budget level. His second term was largely consumed with dealing with the aftermath of Prop 13 and a growing budget crisis that resulted from taking on local bailouts during two back-to-back recessions in the early 1980s. Brown lost a U.S. Senate race to San Diego Mayor Pete Wilson in 1982 and largely disappeared from state politics until the end of the decade. His successor as governor, Republican George Deukmejian (1983-91), was left to deal with the budget crisis which he did – and which won him a second term in 1986.

Meanwhile, Prop 13 had set in motion an ongoing political process. In 1979, Prop 4 was passed as a follow-up to the Prop 13 taxpayer revolt. Prop 4 put a ceiling on state spending based on a formula linked to population growth and inflation. Under Prop 4, if revenue exceeded the ceiling, taxpayers were due a refund. Such a refund occurred during Deukmejian's second term, angering the public school establishment which had become highly dependent on the state in the wake of Prop 13's cut in property taxes. The result was Prop 98 of 1988 (and a related later Proposition 111) which gutted Prop 4's spending cap and required that K-14 funding be based on a complicated system of three alternative contingent formulas.

Although George Deukmejian had been reelected in large part due to his success with resolving Jerry Brown's budget crisis, he left a later budget crisis legacy to his successor, Republican Pete Wilson (1991-99). The new crisis was linked to a national recession but also importantly – as noted earlier – to the end of the Cold War and the resulting structural shift in state growth. Wilson spent much of his first term struggling with the budget. By the time he was up for reelection in 1994, some level of fiscal stability had been achieved, aided in part of the incipient dot-com boom. And by the time his second term ended, Wilson left a buoyant economy and a temporarily-repaired fiscal situation to his successor, Democrat Gray Davis (1999-2003).

Table 1 traces California's fiscal history from the end of the Wilson era through June 30, 2012, the end of Jerry Brown's first complete fiscal year. Data on the table come from the cash statements issued by the state controller for the general fund – the operating budget of the state. They differ from official budget figures for reasons, sad to say, that are never fully explained in the public accounts. Indeed, accounting discrepancies – as will be described below in this chapter

[6] Proposition 13 has been challenged in court on various grounds over the years but has been upheld. At this writing, a lawsuit challenging the two-thirds requirement filed by former UCLA Chancellor Charles Young and others is likely heading to the state Supreme Court. It has been turned down at lower court levels. The suit is premised on the distinction between an amendment to the state constitution – allowed by initiative – and a more fundamental change (not allowed).

– became part of a fiscal scandal by the summer of 2012.[7] Nonetheless, the controller's cash statements provide a general picture of fiscal developments.[8]

For a time, thanks to the dot-com boom, state cash reserves rose substantially and short-term debt of the state was paid off. But at the peak of the boom, the state was already running a deficit, a fact that suggested a budget crisis was inevitable in the coming bust. The state is normally constitutionally barred from borrowing long term for general fund operating costs, but it can borrow short term within a fiscal year externally using a device known as Revenue Anticipation Notes (RANs). And it can borrow internally by putting IOUs into other state accounts outside the general fund. But excessive borrowing internally can interfere with the activities that the non-general fund accounts are supposed to support.[9] If such external and internal borrowing proves insufficient, the next step is short-term borrowing bridging two fiscal years through Revenue Anticipation Warrants (RAWs).

Governor Davis found himself using all three devices during the dot-com bust. Although he won reelection in 2002 against a weak opponent, by the summer of 2003, as noted earlier, he was facing a recall election. Ultimately, Davis was replaced by Republican Arnold Schwarzenegger. Schwarzenegger then faced the budgetary challenge that he had inherited from Davis. The state could in theory have rolled over its Davis-era RAWs into new short-term debt but financial markets were become impatient and punishing interest rates would have been required. Davis had proposed instead rolling over the accumulated short-term debt into a long-term state general obligation bond, a remedy that seemingly was unconstitutional.

Davis had proposed a route that ostensibly would surmount the constitutional bar but as a practical matter was dubious. Such a bond would inevitably face legal challenges and lenders were not likely to buy a bond that could be declared void by some eventual court decision. So Schwarzenegger took the Davis plan, enlarged it, and – using his popularity – persuaded voters to approve a constitutional amendment allowing long-term borrowing on a one-time basis under Props 57 and 58 of 2004. Voters were assured that the state would "throw away the credit card" after the one-time borrowing.

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[7] The state has underway a plan dubbed FI$CAL for integrating the accounting for the various funds that finance its operations. Such an integrated system might (emphasis on "*might*") produce more consistent results. The inability to reconcile the accounts is not entirely a technological issue. On the plan, see Legislative Analyst's Office, "The 2012-13 Budget: Evaluating FI$CAL," April 30, 2012. Available at http://www.lao.ca.gov/analysis/2012/ss/evaluating-fiscal-043012.pdf.

[8] The official budget accounts are reviewed later in this chapter.

[9] For example, the state has a fund that finances beverage container recycling. Deposits on containers go into the fund which subsidizes recycling. At one point, there was so much borrowing from the fund that recycling activity was threatened. In 2010, the legislature took steps to stop additional borrowing and repay old loans. See Legislative Analysts' Office, "Overview of the Beverage Container Recycling Fund," April 11, 2012. Available at http://www.lao.ca.gov/handouts/resources/2012/Overview_of_BCRF_04_11_12.pdf. The fund has other problems including an ostensibly high recycling rate that tends to drain it. There is some suspicion that there may be illegal imports of used bottles and cans from out-of-state to claim refunds.

Schwarzenegger was reelected in 2006 as the housing bubble and its related prosperity was peaking, in part by identifying himself with expanded infrastructure – also on the 2006 ballot – to be paid for with additional borrowing. Once the bubble began to burst in 2007, the state's budget problems returned. The Schwarzenegger agenda became increasingly budget centered and his popularity waned.

By winter 2009, after resisting tax increases, Governor Schwarzenegger went along with a package of temporary tax increases. Because of the two-thirds vote requirement under Prop 13, a few Republican votes were needed and were obtained (barely). But those Republicans who went along with the package were punished by their party. GOP legislative leaders lost their posts and one assemblyman was threatened with a recall, although it never came to pass. But the episode left a legacy which Jerry Brown would inherit under which obtaining Republican votes for taxes was almost impossible. Moreover, voters were unhappy with the new taxes and rejected extending those taxes beyond 2011 in a special election called in May 2009.

Meanwhile Jerry Brown had reemerged in California politics, first as chair of the Democratic Party, then as mayor of Oakland, and then as state Attorney General. Because he had served his prior two terms before voters imposed term limits in 1990, he was eligible for another two terms and ran as the Democratic gubernatorial candidate in 2010. His GOP opponent, former eBay CEO Meg Whitman, despite spending heavily on her own campaign, lost badly to Brown, partly because of "housekeeper-gate," a personal scandal involving hiring an illegal immigrant housekeeper and then firing her abruptly. Brown also ran a successful campaign to tag Whitman as another version of the now-unpopular Schwarzenegger. That is, she was tagged as an outsider candidate from the business world who, unlike Brown (but like Schwarzenegger), would come into office not understanding how government worked.

Brown's First Budget: General Background

"For 10 years, we've had budget gimmicks and tricks that pushed us deep into debt. We must now return California to fiscal responsibility…"

Governor Brown in January 2011 submitting his budget for 2011-12[10]

Although Brown's political comeback began in the late 1980s, his earlier gubernatorial experience had come in an earlier era in which party polarization in the legislature was much less than it was when Brown took office as governor in 2011. In that earlier era, there were centrists in both parties and crossing party lines was not a political death sentence. Indeed, it was not a rarity. Even legislative leaders could be elected by a mix of votes from both parties.

[10] Quoted in a media release by the governor's office dated January 10, 2011. Available at http://gov.ca.gov/news.php?id=16872.

Brown had been elected in 2010 on a pledge of no new taxes without voter approval. As described in last year's chapter, his initial budget strategy was in fact to obtain voter approval for extension of the 2009 temporary taxes. As noted above, however, when given a chance to vote on such extensions in May 2009, voters had rejected the option. In effect, Brown's plan was to have them reconsider and acquiesce, hopefully by June 2011 before the 2011-12 fiscal year would begin.

There are two routes to putting propositions on the ballot. The legislature can do it with a two-thirds vote. Or it can be done by petition. The latter has two disadvantages. First, the petition route costs money, about \$1-\$2 million to hire commercial signature-gathering firms. Despite brave assertions by proponents of various initiatives that they will conduct a grass-roots signature campaign and not hire professionals, as a practical matter you need the professionals to put an initiative on the ballot.

The second disadvantage is that an initiative by petition could not be said to be bipartisan, since it entirely avoids using the legislature. That disadvantage was seen as the advantage by Brown of going the alternative legislative route. Obtaining a two-thirds vote in the legislature would necessarily involve a few Republicans, thus making possible the claim of a bipartisan approach.[11] From Brown's perspective, moreover, all he would be asking from Republicans was to put the issue on the ballot. They would not have to support a "yes" vote.

As it turned out, however, even just giving the voters a tax option on the ballot had become virtually impossible for Republican legislators interested in a continuing political career. When Brown decided to forego the petition route and rely on offering incentives to Republicans to go along with a tax extension proposition, he unknowingly set in motion a process that resulted in no ballot proposition through either route (so the temporary taxes of winter 2009 expired). That expiration posed a problem for Brown since his initial budget proposal of January 2011 was built on an assumption that there would be a proposition and that it would be enacted by voters.

June 2011 proved to be an exciting month for the upcoming 2011-12 budget. In the background was a proposition voters had passed in November 2010 allowing budgets to pass by a simple majority, dropping a two-thirds rule that had a history back to the Great Depression. That is, the legislature could pass a budget with just Democratic votes. But it could not include either a tax increase or a ballot proposition that might lead to a tax increase because either would require two thirds. Brown kept negotiating with Republicans until Democrats panicked and quickly passed a budget that was "balanced" by some definition but only on paper. Brown then vetoed that budget.

[11] There was discussion of a possible route by which a proposition could be put on the ballot by a simple majority if it were dressed up as a modification of an earlier proposition. But there were enough legal doubts to make such an attempt unattractive.

Their panic was a reflection of another element of the proposition that allowed budgets to be passed with a simple majority. The same proposition indicated that if legislators did not pass a budget by June 15 – the constitutional deadline – they would not be paid for days with no budget. Democratic leaders in the legislature argued that they had met their obligation despite Brown's veto. However, the state controller, John Chiang, ruled that the budget passed by the legislature did not meet certain technical requirements and refused to pay the legislature.

Ultimately, since it became clear that there would be no GOP votes and no paychecks, the legislature and the governor agreed on a budget that simply assumed about $4 billion in extra revenue – beyond what was projected for the sum of the taxes actually forecast – and that budget was deemed "balanced" (on paper).[12] Not surprisingly, as Table 2 shows, the assumed extra revenue did not appear. On a cash basis, revenue fell short of the original forecast by over $4 billion.[13] The impact of the gap between actual and assumed revenue was partly offset by inclusion of automatic mid-year "trigger cuts" that would be imposed should revenue fall short of target by varying magnitudes. However, the cuts were not made on a dollar-for-dollar basis and there was no guarantee that the cuts would be made sufficiently large to guarantee the projected end-of-year reserve in the general fund would be positive. Although there were trigger cuts, the target was not met and the general fund ended with a negative reserve at the end of 2011-12.

Looking at the Budget Numbers

"Revenue accounting and reporting practices, however, are becoming increasingly confusing…"

Report of the Legislative Analyst's Office[14]

As noted, reconciliation of the cash and official budget data is not possible. And, indeed, while the cash statements, once they are issued, form an unchanging historical record, in budget data the past, particularly the near past, is quite variable. In part, the problem stems from the use

[12] A court challenge was filed against Chiang, essentially arguing that it was only the legislature that could determine if a budget meeting constitutional requirements had been passed. The controller had no such power, the plaintiffs argued, even though he is the state's paymaster. A court decision endorsing that view eventually was issued but the legislators never asked for, nor were they given, back pay for the episode. Meanwhile, the case is on appeal by Chiang as of this writing. Chiang waited until a budget deal was struck for 2012-13 before filing his appeal.

[13] One study found that government agencies around the world have a tendency to be overoptimistic about their projections so California is not necessarily unique. However, the current rules (since 2010) allowing a simple majority to pass budgets but a two-thirds vote for tax increases or certain other actions may encourage such behavior. See Jeffrey A. Frankel, *Over-Optimism in Forecasts by Official Budget Agencies and its Implications*, working paper 17239, July 2011, National Bureau of Economic Research. Available at http://www.nber.org/papers/w17239.

[14] Quoted in Legislative Analyst's Office, "Issues Concerning the Accounting of California's Special Funds," August 9, 2012. Available at http://www.lao.ca.gov/handouts/state_admin/2012/Accounting_Special_Funds_8_9_12.pdf.

of accrual methodology by the governor and legislature for budget data. Accrual in principle means assigning revenue to when it becomes owed to the state as opposed to when it is actually received. For example, income tax for 2012 is due on April 15, 2013 but accrues to the state during 2012.

Unfortunately, in practice, the accrual approach, as actually applied by governors and legislatures, opens the door to moving around revenue and expenditure in ways which obscure – rather than enhance – an understanding of the budget. The Legislative Analyst has recommended that a consistent methodology for accrual be required by law. [15] It may be, however, that given the pressures to adjust figures in ways that are convenient, a return to cash accounting – despite its drawbacks – should be considered.[16] What is inferior accounting in theory may be superior in practice.

Table 3 shows four depictions of the 2011-12 budget from four sequential budget documents. On the left is shown the budget as officially enacted, including the last-minute $4 billion phantom revenue that was assumed. In the official document, the state was going to run a budget surplus of about $2.5 billion during the year, turning the reserve in the general fund from a negative $1.2 billion to a positive $1.3 billion by the end of that year.

When the governor presented his budget for the upcoming 2012-13 in January 2012, his estimate of the then-current 2011-12 year was that the budget – rather than running a surplus – was in fact running a slight deficit. The estimate reserve at the beginning of the 2011-12 year (six months before) had mysteriously become more negative, -$3.1 billion instead of -$1.2 billion. Yes, there were explanations; no, these were not helpful.

When the governor issued his "May Revise" for the upcoming 2012-13 year, his estimate of the negativity of the reserve 10 months earlier had dropped by a little over $200 million and the budget for the year as a whole was to be in a slight surplus. And by the time of budget enactment, the negativity in the reserve at the beginning of 2011-12, now 12 months earlier, had dropped slightly again. In flow terms, the 2011-12 budget was shown as being in a slight surplus but nonetheless ending with a negative reserve of about -$2.9 billion. As noted, the cash statement shows the budget running a deficit and – in absolute terms – a much larger negative reserve at the year's end.

[15] Legislative Analyst's Office, "The 2012-13 Budget: Overview of the Governor's Budget," January 11, 2012, pp. 16-17. Available at http://www.lao.ca.gov/reports/2012/bud/budget_overview/budget-overview-011112.pdf.

[16] The Government Accounting Standards Board (GASB – generally pronounced gaz-bee) suggests using cash inflows and outflows to depict short term matters and accrual to depict long term obligations. See GASB, "Economic Conditions Reporting: Financial Projections," November 29, 2011. Available at http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176159500453.

Table 3 also shows the governor's proposals and the eventual enactment of the subsequent budget for 2012-13. We will return to the proposals and enactment in the narrative below. As pointed out in the introductory section, the budget – although it is enacted in discrete units for particular fiscal years – is in fact a continual process. One year's budget blends into the next.

New Fiscal Year and New Approaches

"…We're not finished."

Governor Brown on signing the 2011-12 budget[17]

If anything was learned by Governor Brown from the legislative process that produced the budget for 2011-12, it was that political polarization meant that there would be no prospect for cooperation from Republican legislators regarding the next budget. The world had changed since the late 1970s when he first entered the governor's office, a period in which cross-party deals and compromises were more common. Budgeting via compromise was no longer on the table.

Governor Brown – who wanted to be the governor who ended California's ongoing fiscal instability – surely had to be uncomfortable with signing a budget that was premised on a phantom $4 billion windfall that would come from no-one-could-say-where. His initial idea on taking office had been to obtain voter approval for a tax extension. Now that the taxes he wanted to have extended had in fact expired, he couldn't pursue the extension approach. He could still ask voters for more tax revenue, but any such permission would have to come through the initiative process and not via a proposition enacted by the legislature (which would require GOP votes). And he would face the disadvantage of having to ask voters for new taxes, not extensions of old – albeit temporary – ones.

Thinking Big

"I've never seen a CEQA exemption that I don't like."

Governor Brown commenting on the state's major environmental law often used to block big projects by opponents[18]

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[17] Quoted in "California's $85.9 Billion Budget: Here are the Major Provisions," *Sacramento Bee*, July 1, 2011. Available at http://www.sacbee.com/2011/07/01/v-mobile/3740427_californias-859-billion-budget.html.

[18] Quoted in David Siders, "California Gov. Jerry Brown Upsets Environmentalist Friends with his CEQA Critique," *Sacramento Bee*, July 31, 2012. Available at http://www.sacbee.com/2012/07/31/4676598/california-gov-jerry-brown-upsets.html.

There were other signs of a gubernatorial shift in approach. The not-like-dad stance that characterized his first iteration of governor had disappeared with regard to big infrastructure projects. Pat Brown had been identified with freeway construction, a major water project, and expansion of public colleges and universities. Jerry Brown now endorsed a large-scale project involving construction of a high-speed rail system connecting the Bay Area and Southern California, despite substantial opposition. He compared high-speed rail to the building of the Transcontinental Railroad in the 19th century. Brown also promoted a successor plan to the Peripheral Canal, a water project that had been defeated by voters in 1982 during his earlier term as governor, and which again sparked considerable opposition.

One overarching element of big infrastructure spending that remained undecided, apart from particular projects, was how to pay for whatever infrastructure the state wanted to support. Basically, there are two methods for funding infrastructure. You can borrow for it so that the eventual payment comes from either future general revenue or revenue that the projects themselves may ultimately generate. Or you can fund it out of current revenue on a pay-as-you-go basis. In recent years, the split between the two methods has been 65% vs. 35%, respectively. Given the structural shift in California's growth since 1990 discussed earlier and the prospect that such restrained post-1990 growth would continue indefinitely, a possible shift in infrastructure finance and planning seemed also to need attention. But apart from reports by the Legislative Analyst and the State Treasurer, however, the focus remained on particular projects and not the more general funding issue.[19]

Summertime 2011

"People are saying, 'Where can we sign up?' and 'Let's set up a Facebook page.'"

Riverside County Supervisor Jeff Stone
concerning his proposal to have southern California
secede from the rest of the state due to the state budget[20]

Since there was not going to be a tax-extension ballot in the fall of 2011, what might have been a busy summer preparing and fundraising for a campaign was relatively quiet from a political viewpoint. However, cuts in the budget enacted in June began to be felt. CalWORKs benefits ("welfare") were cut as of July 1. At later dates in the year, other social welfare

[19] California Legislative Analyst, "A Ten-Year Perspective: California Infrastructure Spending," August 2011. Available at http://www.lao.ca.gov/reports/2011/stadm/infrastructure/infrastructure_082511.pdf. The Treasurer noted that he projected debt service would rise to 7.8% of the general fund in 2011-12, more than double the percentage in 2003-04. California State Treasurer, "The Challenge Ahead: Balancing California's Infrastructure Investment and Service Needs," October 2011. Available at http://treasurer.ca.gov/publications/2011dar.pdf.

[20] Quoted in Dave Downey, "Riverside County Supervisors Cool to Idea of Calling for Secession," *North County Times,* July 2, 2011. Available at http://www.nctimes.com/news/local/sdcounty/article_a9170e74-b533-5eaf-a7ee-e11810ba0ea5.html.

spending was reduced in such areas as adult daycare, child care, and Medi-Cal. Higher ed spending was cut, triggering proposals for increased tuition.

A Riverside County supervisor called for southern California to secede, angered by the revenue squeeze imposed on cities (such as San Bernardino, later to declare bankruptcy) and lack of state funding to open a UC-Riverside medical school. The City of Santa Clarita turned its library system over to a private contractor to save money. Brown angered organized labor by vetoing a bill allowing a "card check" system of union recognition in agriculture.[21] But since there would be no campaign for a tax extension initiative which would have been largely funded by public sector unions, there was little risk for Brown in the veto.[22] In addition, the legislature added anti-layoff protections for school teachers thus pleasing the powerful California Teachers Association, a union far more influential in Sacramento than the United Farm Workers.[23] And a bill in the legislature, which the governor ultimately signed, created some obstacles for local governments seeking blanket bans on project labor agreements, an issue important to construction unions.[24]

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[21] The federal government does not regulate labor relations in agriculture and the state therefore has jurisdiction through its Agricultural Labor Relations Act (ALRA), a statute enacted during Brown's first iteration as governor. In that period, Brown was identified with Cesar Chavez's campaign to unionize farm workers which had some success but which fell apart in the 1980s. Under the ALRA, workers can choose to be unionized through an election process similar to what workers in the nonagricultural private sector have through federal law. "Card check" is a less formal procedure under which union recognition could be obtained by having a sufficient number of cards signed by farm workers saying they wanted a union to represent them. It makes union success in gaining employer recognition easier. Brown later signed a lesser bill favored by the Farmworkers that permitted the Agricultural Labor Relations Board to certify a union representative if it could be shown that workers were being intimidated by their employers to remain nonunion during organizing campaigns.

[22] One union that did take a hit in the budget in the form of layoffs was the California State Law Enforcement Association representing certain workers in the Attorney General's office. The union had endorsed Meg Whitman for governor in 2010 and was responsible for promoting the "whore-gate" affair. The affair involved a recording in which someone on the governor's staff (the person could not be identified) referred to Whitman as a whore for exempting police from her pension proposals. Whore-gate never caught fire as a scandal, however. There was, not surprisingly, speculation that the layoffs were retribution for the union's 2010 election actions. Another law enforcement union, the once powerful California Correctional Peace Officers Association (prison guards) suffered a loss, but not from gubernatorial action. It had attempted to reverse Schwarzenegger-era furloughs that had been imposed on its members on the grounds that the days off could not actually be taken because of scheduling problems in the prisons. The union had won a lower court decision upholding its position but that verdict was overturned on appeal. (Generally, legal challenges to state furloughs from the Schwarzenegger period did not succeed but in a few cases there were some reversals – and litigation {appeals by the state} pending at this writing concerning such reversals.)

[23] School districts were instructed to budget on the assumption that there would be no trigger cuts which might require layoffs.

[24] Project labor agreements can occur in both the public and private sectors. In either case, builders sign an agreement with various construction crafts that bar strikes and set up an alternative mechanism for resolving disputes. In effect, the agreements mean that the builders will use unionized construction contractors and workers. The bill signed by Governor Brown did not require local governments to use such agreements but did forbid them from enacting a *blanket* ban. Thus, each possible agreement had to be considered on a case-by-case basis.

If there was drama in the aftermath of the 2011-12 budget's enactment, it was over the imposition of the "Amazon tax," a requirement that Internet retailers with no presence in California nevertheless collect sales tax on purchases from within the state.[25] Amazon initially refused to collect the tax and cut off its relationship with California suppliers, hinted at a lawsuit, and put money into a referendum to repeal the requirement.[26] The legislature responded with a bill that, if passed, would have effectively made the requirement to collect the tax referendum-proof.[27] At one point, Amazon proposed it would open some distribution centers in California if the state would drop the tax collection requirement. In the end, Amazon agreed to a delayed version of the tax collection requirement and dropped its plans for a ballot measure.[28]

Another drama that also began in the summer of 2011 involved local redevelopment agencies. These agencies relied largely on "tax increment" financing for their activities. The agencies would redevelop areas – ostensibly to remove blight but often to promote general local economic development – through receipt of the added property tax that would come as a result of the increased property valuations due to the redevelopment. They could float bonds against the stream of future property tax revenue. The problem for the state evolved out of Prop 98's guarantees to K-14 for formula-based funding. To the extent that local property tax was "diverted" to redevelopment agencies, the state had to make up the property tax lost thereby to schools.

During the ongoing budget crisis, the state had found various ways of trying to capture local revenue – including revenue that would otherwise go to redevelopment. In 2010, local authorities – including redevelopment agencies – put a proposition on the state ballot that appeared to ban what they regarded as state revenue grabs of their monies. Voters approved the proposition but the victory from the viewpoint of the redevelopment agencies was short lived.

When Governor Brown proposed his 2011-12 budget, he proposed completely abolishing redevelopment agencies. If they did not exist, he reasoned, taking their money was not prohibited. The upshot was a compromise deal under which, rather than be abolished, the agencies would "voluntarily" pay the state under protest and then take their legal case to the

[25] Apart from the loss of state revenue when online sales occur and sales tax is not collected, state retailers lose sales since their prices include the tax. See Liran Einav, Dan Knoepfle, Jonathan D. Levin, and Neel Sundaresan, *Sales Taxes and Internet Commerce*, working paper 18018, National Bureau of Economic Research, April 2012. Available at http://www.nber.org/papers/w18018.

[26] Technically, California buyers from firms such as Amazon were required to remit the sales tax on their own, even though it was not added to the purchase price. In reality, few customers did so and the law was not enforceable, thus costing the state lost revenue and angering California retailers that were subject to the tax and that had to compete with companies such as Amazon.

[27] The bill would have an urgency clause preventing a referendum. Such a clause would have required a two-thirds vote, i.e., some Republican support. Because California retailers supported the bill (to prevent Amazon from having a tax-free advantage), it was thought that some Republican votes might be forthcoming. When it came up to a vote, however, no Republican votes could be found.

[28] The deal was that Amazon and other online retailers would lobby Congress for a uniform national law. If no law emerged (and none has at this writing), Amazon would start collecting California tax by mid-September 2012.

courts. As it turned out, litigating the issue was a big mistake for the redevelopment agencies. In the end, the California Supreme Court ruled against the voluntary payments but supported the right of the legislature to abolish the agencies entirely. The agencies thus litigated themselves out of existence. But during the summer of 2011 this outcome was not expected; the agencies made their voluntary payments under protest and pursued their inadvertent judicial path to oblivion.

There were others who did not foresee exactly where their budgetary actions would lead. Democratic Assemblyman Anthony Portantino had refused to go along with his party's vote for the 2011-12 budget which contained more cuts than he wanted to support.[29] As a result, his office budget was slashed, officially because of past overspending. Portantino retaliated by demanding and litigating over public access to other legislative budgets and other information, information the legislative leaders were not anxious to share. He released his own information and challenged Assembly Speaker John Pérez to do likewise for all Assembly members. Portantino eventually succeeded in forcing a partial information release and the cuts to his office budget were reversed. Still more information was released when newspapers took the issue to court – and won – in January 2012.

And there were other repercussions. The Cal State System recruited a new president of San Diego State at a substantially higher salary than his predecessor, sparking public outrage and a letter protesting the arrangement from the governor. Pay of State University presidents remained an issue, even after the Board of Trustees of the System established a plan whereby future salaries would be capped and salary bump ups would be paid using non-state foundation funding.

If large dollar amounts were involved for university presidents, much smaller amounts caused confusion for motorists whose car registrations expired over the summer of 2011. One of the 2009 tax increases that might have been extended – but wasn't – was the Vehicle License Fee ("car tax"). The drop was partly offset by another fee but because of budgetary uncertainty, the California Department of Motor Vehicles was delayed in getting out notices for registration renewals. When the notices finally went out, car owners had little time to comply or were told their fees were overdue. In practice, however, additional time to pay fees was eventually granted.

No fee dispensation was given to rural residents who rely on state firefighting services. A proposal for a firefighting fee had been proposed during the Schwarzenegger era but was finally enacted as an element of the 2011-12 budget. Not surprisingly, such residents preferred to have such services provided for free and protested the new charge.

[29] Portantino was termed out but was said to be considering a run for Congress in a liberal district in which his opposition to the cuts might have voter appeal. He made preliminary moves for such a run but later pulled out of the contest, citing family obligations.

Another user charge is public university tuition, increases in which had sparked student demonstrations and protests. Under the new 2011-12 budget, even without the trigger cuts that were contingent on phantom revenue, the ratio of tuition revenue to tax revenue for students was rising. At the University of California (UC), for example it was noted that the ratio had reached the point where more revenue was coming from tuition than from the state budget.[30] The issue was contentious enough that the Regents refused to consider a long-term schedule of tuition increases at their September 2011 meeting that had been proposed by the UC administration. They did endorse a proposed tobacco tax ballot proposition that would fund cancer research to be on the June 2012 primary ballot, since some of the funding would spill over into UC medical center research. (The proposition was narrowly defeated.)

The public pension issue – about which a later section in this chapter will be devoted – continued to simmer during the summer. When Governor Brown was negotiating, without ultimate success, with Republicans for support in putting a tax-extension proposition on the ballot, he offered various limits on public pensions in California. Had a deal along those lines been struck, 2011 might have seen major changes in pensions on the ballot and much activity on that issue during the summer. But no deal occurred. Pensions remained largely a matter of local concern; San Francisco placed a pension measure on the ballot for the fall and almost a year later pension propositions were passed by voters in San Jose and San Diego.

To some extent, the pension issue stood as a proxy for battles in other states with Republican governors and legislatures, most notably in Wisconsin and Ohio.[31] Various constraints in those states were placed on public unions – that tend to fund Democratic candidates – including eliminating public sector bargaining or constraining union political funding abilities. Given the political tilt in California, such drastic steps were not feasible at the state level. And threats of political groups to put a statewide pension initiative on the ballot foundered without sufficient funding for such an effort.[32]

But some local jurisdictions with conservative political leaders and voters moved, to the extent they could, in related directions. Notable was the southern California City of Costa Mesa where the activity took the form of outsourcing as much of the local public sector as possible. The city council also undertook moves to become a charter city which would reduce the influence of the legislature on the municipality with regard to its actions. Those actions received

[30] Much of the UC budget comes neither from the state nor from tuition. Federal and other research grants, hospital patient revenues, and other sources account for more than three fourths of the budget.

[31] Opponents of a pension measure on the ballot in San Francisco noted that large donors to the Wisconsin and Ohio efforts were also providing funding for the San Francisco campaign. See Heather Knight, "SF Pension Reform Donors Tied to Antiunion Efforts," *San Francisco Chronicle*, October 4, 2011. Available at http://www.sfgate.com/news/article/SF-pension-reform-donors-tied-to-antiunion-efforts-2328609.php.

[32] A group called California Pension Reform filed two initiatives but could not raise the funding for signature gathering, let alone a ballot campaign, and dropped its efforts in early February 2012. The group blamed the summary written by the Attorney General for the measures for scaring off potential donors with language about teachers, nurses, and police.

national attention when one city worker committed suicide by jumping off the roof of city hall. And much litigation over outsourcing and other issues, some still underway at this writing, followed.

Although other cities were to follow a year later, the only California city in actual bankruptcy during the summer of 2011 was Vallejo. Vallejo emerged from bankruptcy with reduced pensions for new hires and higher pension contributions for incumbent workers. Pensions of retirees were not affected. Some other cities – indeed, the League of California Cities – had hoped for a test of the legal position that pensions already promised to current workers cannot be touched. However, Vallejo – in part because of pressure from CalPERS – the very large pension covering state employees (other than UC and certain other state groups) and many local jurisdictions – not to push in that direction.

Republicans in the legislature had been able to keep the governor negotiating on the idea of a tax extension proposition until June when he gave up and the minority party essentially lost any voice in the enactment of the 2011-12 budget. But the GOP still had some potential future power due to the two thirds vote requirement for taxes and certain other legislative actions. The problem was that even that limited leverage could end given the new redistricted legislative boundaries drawn up by the citizen commission mentioned earlier that voters had set up. Although taking redistricting out of the hands of the Democratic legislature had long been a GOP goal, it appeared that even the new districts could conceivably give Democrats two-thirds control.

Republicans filed an initiative in August 2011 that challenged the new districts that had been drawn up but just those districts for the state senate. They did not challenge assembly or congressional districts. Ultimately, they raised the funds needed to gather the needed signatures. Ironically, when the needed signatures had been gathered and the measure went on the ballot for November 2012, Republicans abandoned the campaign. It was too late to take the initiative off the ballot but the "pro" argument in the ballot pamphlet for what became Prop 40 told voters that the initiative was no longer needed.[33]

Even as the summer of 2011 was drawing to a close, Governor Brown appeared to be looking ahead to proposing a new budget for 2012-13. Given the lesson learned from the 2011-12 process – that there would be no Republican support for any tax measures – the governor knew that if he wanted new taxes, he would have to go the initiative route. The legislature, however, had passed a bill that would require paid signature gatherers to wear buttons indicating they were hired hands – a provision that would make signature gathering more difficult. Brown vetoed the bill. He also vetoed proposed changes in the trigger cuts contained in the 2011-12

[33] The rationale given for this unusual ballot argument was that the state Supreme Court had allowed the 2012 election to go forward with the new districts in place. It was unclear why the issue was pursued as long as it was. Early polling suggested that voters were not keen on overturning a system they themselves had created.

budget agreement. If the trigger were pulled – as seemed likely – whatever saving it generated would be needed.

Fall 2011

"Unfortunately, there are few easy options left for balancing California's budget. Difficult program reductions have already been passed and significant one-time actions may be more elusive than in prior years. Accordingly, the remaining work of eliminating the state's persistent, annual deficit will require more difficult cuts in expenditures and/or increases in revenues."

November 2011 report of the Legislative Analyst[34]

Even before the date where the trigger might be pulled, the budget squeeze in California reached out of the state. In early October, the U.S. Supreme Court agreed to hear a challenge to Medi-Cal (Medicaid) cuts filed by health care providers whose reimbursements were cut. In accepting federal funding, the states must meet federal rules for access to health care by the poor. If payments to providers are cut to the point where many of them drop out of the program, that access could be compromised.

But much of the fiscal action was within-state. There were glimmers of coming trigger cuts when the state controller reported that revenues for the first quarter of the 2011-12 budget year were over $700 million below budget forecasts. Brown signed a bill allowing the California Department of Parks and Recreation to avoid budget-related state park closures by making deals for private funding through nonprofit groups. This seemingly non-controversial bill was to come back to haunt the governor in his campaign to persuade voters to enact a tax increase a year later. As will be described below, a major scandal erupted when it turned out the Department had funds in accounts that it did not know about and which might have averted park closures without external fundraising.

Although the parks bill's future implications were not understood, there was a strategic move in the legislature to change the initiative process in ways likely to benefit Democrats. Up to that point, initiatives that were certified as having sufficient signatures would be placed on the next election ballot, which could be a primary or special election as opposed to a regular general election in November. The next ballot in 2012 would be the presidential primary seen as more likely to turn out Republicans than Democrats. (President Obama was the sure Democratic nominee. But in the fall of 2011, the Republican race was open and conceivably there might be

[34] Legislative Analyst's Office, "The 2012-13 Budget: California's Fiscal Outlook," November 2011, p. 2. Available at http://www.lao.ca.gov/reports/2011/bud/fiscal_outlook/fiscal_outlook_2011.pdf.

no all-but-anointed candidate by the time of the California primary. Republicans would then be more likely to vote than Democrats.)

The Democrats' bill moved initiatives to the November general election only. This move left only two statewide propositions on the June 2012 primary ballot. There was a relaxation of term limits which passed. And there was a tobacco tax which – as will be discussed below – narrowly failed.

One item that might have ended up on the June primary ballot was a "paycheck protection" initiative. Under paycheck protection, unions would be forbidden to use dues money for political purposes and corporations would be forbidden from making employee payroll deductions for political purposes. This seemingly-balanced formula in fact was aimed at unions since corporate political campaigns are not typically funded by payroll deduction. Basically, since union money goes mainly to Democrats, it would defund Democrats and initiatives favored by Democrats such as any tax initiative that might be part of the 2012-13 budget. The bill that was passed by the legislature and signed by the governor did not prevent paycheck protection from appearing eventually on the ballot; it did wind up on the November 2012 ballot but not in the June primary. Republicans filed a referendum to overturn the bill but never obtained the required signatures.[35]

By the fall of 2011, as noted earlier, only one city in California had declared formal bankruptcy, Vallejo, a Bay Area city with a population of about 116,000. That bankruptcy, filed in May 2008 before the full weight of the financial crisis was felt, was an early product of the housing bust.[36] As it turned out, however, by summer of 2012, there were other municipal casualties that ended in bankruptcy proceedings: Stockton, Mammoth Lakes, and San Bernardino. The state's tendency to pull local revenue up to Sacramento was in the background but, of course, each fallen city had its own special story.[37]

Since it was evident from the Vallejo example that other such bankruptcies might follow, the governor signed a bill that would set in motion an investigative process in some cases before bankruptcy could be declared. The bill was heavily favored by public-sector unions that feared their labor contracts might be abrogated by a bankruptcy judge. On the other hand, Governor Brown continued his pattern of sometimes giving something to organized labor and sometimes not. He vetoed a bill requiring local government to undertake economic impact studies when "big box" stores – read Wal-Mart – applied for building permits. Nonunion Wal-Mart has been

[35] As noted earlier, another Republican-backed referendum for which signatures were obtained sought to undo the district lines drawn by a citizens' tribunal for the state senate. This initiative eventually appeared on the November 2012 ballot but was abandoned by its backers.

[36] On Vallejo, see Charles D. Sakai and Genevieve Ng, "We're Bankrupt… Now What?," *CPER Journal*, May 2010, pp. 5-12. Available at http://www.publiclawgroup.com/wp-content/uploads/2011/12/2010-05-Were-Bankrupt-Now-What.pdf.

[37] The bankruptcy of Mammoth Lakes seemed linked to a dispute with a developer rather than deeper causes.

anathema to unions, particularly those representing workers in unionized grocery chains, because of its anti-union stance and its competition with union supermarkets.

While some municipalities were slowly edging toward bankruptcy, counties were in a different position. Thanks to the "realignment" component of the 2011-12 budget, certain state prisoners were to be moved to county jails and supervision. Past bond money was made available to counties to enlarge their jails, creating a local building boom of sorts. But at least in the short run, in some counties there was a shortage of facilities – both physical and in the form of parole agents – to handle the added responsibility. Some local police officials worried about increased crime as a result of realignment although their public statements tended to give reassurance that the new responsibilities would somehow be handled. Whether votes would connect increased crime – if it occurred – with the state budget and possibly some future tax initiative was unclear.

Pension Tension

"We view the Governor's (pension) proposal as a bold starting point for legislative deliberations."

Legislative Analyst's review of
Governor Brown's pension proposals[38]

"You got resources, brother, we got resources too. If you want a war we did not start, let's get it on."

Union spokesperson reacting to a City of Los Angeles proposal
to adopt a lesser two-tier pension plan for new hires[39]

Perhaps the biggest budget-related event was the proposal by the governor for a revamp of all state and local public sector pension plans. "Budget-related" may not be a good term, however, because in the short term, pension costs, while rising, were not a major part of the state budget crisis; the basic cause was the overall structural problem described earlier plus the Great Recession. Still, the pension problems of the state to some degree were a reflection of the gap between public expectations and fiscal reality that developed post-1990.

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[38] Legislative Analyst's Office, "Public Pension and Retiree Health Benefits: An Initial Response to the Governor's Proposal," November 8, 2011. Available at http://www.lao.ca.gov/reports/2011/stadm/pension_proposal/pension_proposal_110811.pdf.

[39] Quoted in Kate Linthicum, "L.A. Council Considers Two Tax Increases and a Pension Change, *Los Angeles Times*, August 22, 2012. Available at http://www.latimes.com/news/local/la-me-0822-city-tax-hikes-20120822,0,7359532.story.

Public employees generally have "defined benefit" pensions, i.e., a retirement annuity whose monthly value is determined by a formula related to the retiree's length of work service, his/her earnings history, and the age at which retirement is taken. Such plans were once common among larger private employers, too, but have gradually been abandoned in favor of "defined contribution" plans in which the employer makes a contribution to a tax-preferred savings account whose investments are then managed by the employee from a menu of options. Whether there is enough in the account to provide an adequate retirement benefit will reflect the amount of the contributions and the employee's skill (luck?) in investments plus how long he/she lives.[40]

There are essentially three issues that arise with defined benefit pensions. First, sloppily-constructed defined benefit formulas can be gamed by employees. The goal of defined benefit pensions is to provide a continuance of income in some relation to *normal* work income after retirement. Thus, the formula for the monthly annuity should reflect only normal earnings, not an artificial spike in earnings typically just before retirement. It is relatively easy to ensure against such pension "spiking," however. Basically, the earnings history used for calculating the pension should involve a multi-year period and should exclude erratic jumps in income from bonuses, overtime, unused vacation time, etc. Not all public plans, unfortunately, use formulas that block such abuses.

Second, defined benefit pensions are promises in lieu of other forms of worker pay. When workers are paid partly in promises, the promises should be adequately funded *at the time those promises are made*. Otherwise, workers providing services today will be effectively be paid by future generations that did not receive those services. Funding current service consumption adequately requires a willingness to pay into the plan an amount which, assuming a realistic assessment of future earnings, will cover current promises. Pension wonks refer to this sum as the "normal cost" of the pension.

In fact, as was the case with many American households before the Great Recession, there was a tendency to charge current consumption to the future. Pension administrators made unrealistic estimates of future earnings of the funds they held in their portfolios and did not put away the normal cost, year by year. Households similarly assumed that their homes would forever appreciate at high rates. In effect, they borrowed for current consumption against that unrealistic expectation and did not adequately save. Now both pension administrators (and taxpayers) and households face the bills for their past excesses.

That sad result has produced the third (political) problem for public pensions. Households, particularly baby boomers who assumed that their houses and inadequate savings

[40] Employees on retiring can take the funds in their defined contribution accounts and buy a lifetime annuity from a private insurance company. Such annuities insure against the risk of outliving the amount saved. But private annuities typically are costly and are not government-insured. Private defined benefit plans are government-insured, in contrast. State and local defined benefit plans are not federally insured but, as will be explained below, are relatively ironclad obligations of the government employer.

would pay for their retirements, are facing retirement years with incomes less than expected. When they look at public workers with defined benefit pensions that protect them from such unhappy results, they resent not having such plans.[41]

Public pensions became an issue in the 2010 California gubernatorial election campaign. Brown during that campaign said he would provide some form of pension reform – without saying what that would be. He offered various pension proposals to the Republican legislators he was trying to induce to put tax extensions on the 2011 ballot. But – as noted – he could not reach a deal with them. So he waited until October 2011 to offer a pension proposal to the legislature and the general public. His 12-point plan for all state and local pensions, which would have applied to new hires only, involved a "hybrid" mix of defined benefit and defined contribution, caps on pensions, higher employee contributions, and protections against spiking and other perceived abuses.[42] Some of these ideas were those offered by the governor to GOP legislators during his unsuccessful budget negotiations regarding the 2011-12 budget and leaked to the news media at the time.

While the governor's proposal took the form of a lengthy document, it was not initially presented as a detailed piece of legislation and would have required voter approval for some elements.[43] More importantly, the proposal was not entirely clear. For example, the governor proposed a cap on retirement benefits of 75 percent of final earnings. But exactly how do you cap a mix of defined benefit and defined contribution where the latter is essentially variable and would depend on how much an employee had earned on the funds in his or her account?[44]

The governor's 12-point program did not meet with favor from public sector unions or Democrats in the legislature who were nonetheless polite and just thanked the governor for his thoughts. Since that reaction was predictable, it is possible that Brown offered the plan as an opening bid in a *de facto* negotiation and was prepared at the time to accept less. Republicans, however, scored political points by fully accepting the plan just as offered by the governor. Although as the minority in the legislature they could not enact it, they could point to the spectacle of Republicans endorsing the governor's plan while his fellow Democrats did not.[45] Meanwhile, some Democrats pushed a plan (SB 1234) that would have expanded the CalPERS

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[41] In reality, almost all private sector workers do have a defined benefit pension plan: federal Social Security. Social Security covers many – but not all – state and local workers. Thus, some public defined benefit pension plans cover workers who do not have Social Security.
[42] The plan dated October 27, 2011 is available at http://gov.ca.gov/docs/Twelve_Point_Pension_Reform_10.27.11.pdf.
[43] Detailed language was presented in early February 2012.
[44] CalPERS – the largest state pension plan – raised this question and others in its draft analysis of the governor's plan. The draft analysis is available at http://www.calpers.ca.gov/eip-docs/preliminary-analysis.pdf.
[45] There was ongoing discussion about groups allied with Republicans filing some kind of pension initiative. But there was never the money available to finance such a move. While filing is cheap, obtaining signatures is costly. And an actual campaign for a ballot initiative would be still more costly. At the local level, however, some pension ballot propositions were proposed and adopted by voters.

state pension in some form to the private sector for those private workers without employer-based pensions.[46]

After the fall 2011 announcement and the flurry surround it, pensions receded into the background during winter and spring, although there were legislative hearings. As in the prior year, the attention went back to the budget during that period and pensions did not resurface as a major issue until August 2012 when the legislature began to develop its own version of pension reform. That episode will be discussed below. However, by the time Brown put out his pension proposal, he surely had sufficient knowledge about the upcoming budget to know that he would be seeking a ballot initiative for a temporary tax increase. In fact, a little more than a month after presenting his pension program, he filed such a tax initiative.[47]

Governor Brown likely believed that showing the public that he had accomplished some version of pension reform would help in the future campaign to pass his tax initiative. However, even if his 12-point plan were implemented in full, the impact on the immediate budget was quite limited and the long-term savings of such proposals tend to be less than proponents suggest.[48] But the issue was delicate since he would need union support to run a campaign for his tax initiative. Because of the paycheck protection initiative that would also appear on the November 2012 ballot, unions' funding for other politics would be more limited than otherwise. Their first priority would be fighting paycheck protection.

In the end, a pension bill was negotiated between legislative leaders and the governor and enacted at the tail end of the legislative session in August 2012. The deal gave the governor the ability to cite a pension reform as part of his campaign for his tax initiative. However, the bill retained the defined benefit structure of public pensions and did not include a defined contribution component as the governor originally proposed. It included a pension cap, although generally not the tight cap the governor had originally proposed, and later retirement ages for new hires. Existing workers would pay higher contributions toward their pensions.

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[46] Oddly, this idea had surfaced earlier in the form of a confusing initiative filed by the same right/populist group that had started the recall against Governor Gray Davis. There is some evidence that public pension plans throughout the U.S. generally follow the lead of CalPERS in their portfolio allocations. See Nancy Mohan and Ting Zhang, "An Analysis of Risk-Taking Behavior for Public Defined Benefit Pension Plans," W.E. Upjohn Institute working paper 12-179 (2012). Available at http://research.upjohn.org/up_workingpapers/179/. So it is possible that any changes in the general structure of CalPERS would have national implications. However, at this writing, discussion of extending some version of CalPERS to the private sector – while it has attracted some media attention – seems unlikely to be enacted in the foreseeable future.

[47] The first version of the initiative was filed on December 1, 2011. As will be discussed below, that version had to be replaced later with another.

[48] Plans that affect new hires only have an impact as new hires occur but there tend to be fewer new hires than normal during periods of fiscal distress. In addition, most public employers in general terms try to pay their employees in total compensation something approximating private sector pay for equivalent jobs. Generally, studies of public/private pay differentials show rough comparability – particularly if employer size is considered – although public compensation tends to have a larger share of benefit-type pay in the wage-benefit mix. So if pensions or other benefits are reduced, over the long run some other form of pay will need to be increased.

The bill did not cover all state and local plans – exempting certain city retirement plans and the University of California, for example – unlike the original governor's plan which seemed to apply to all public pensions in the state. However, when the August 2012 deal was announced, the governor chose to characterize it as "a significant step forward."[49] As news stories began to point to the fact that the deal was less extensive than the original 2011 proposal, Governor Brown enhanced his description. The deal became "the biggest rollback of public pensions in California history."[50] At the state level, however, it was unclear that there ever had been any prior rollback.

Winter Arrives

"I don't know of another approach than the triggers we already voted on."

Assembly Speaker John Pérez quashing talk that the legislature would modify existing budgetary triggers[51]

"Nemo dat non habet."

Governor Brown (former classics major at UC-Berkeley) announcing trigger cuts ("*No man gives what he does not have*.")[52]

Shortly after the original pension plan announcement in 2011, the Legislative Analyst had released his review of the budget problem facing the state. As the Analyst saw it, although California had run a surplus in 2010-11, thanks to the temporary tax increases enacted in 2009, with the expiration of those taxes, California would run a deficit in 2011-12, even with a probable trigger cut. Thus, the already-negative reserve in the general fund would be still more negative by the end of June 2012. And the problem would intensify in 2012-13, absent further revenue enhancements and/or spending cuts.[53]

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[49] Quoted in gubernatorial media release of August 28, 2012. Available at http://www.gov.ca.gov/news.php?id=17694.

[50] Quoted in gubernatorial media release of August 31, 2012. Available at http://www.gov.ca.gov/news.php?id=17701.

[51] Quoted in John Myers, "Rethinking Budget Trigger Unlikely, Says Speaker," *KQED Capital Notes*, November 28, 2011. Available at http://blogs.kqed.org/capitalnotes/2011/11/28/rethinking-budget-trigger-unlikely-says-speaker/. An earlier attempt by the legislature to modify the trigger was vetoed by Governor Brown in September 2011.

[52] Quoted in John Myers, "Brown Announces Some, Not All, Budget Trigger Cuts," *KQED Capital Notes*, December 13, 2011. Available at http://blogs.kqed.org/capitalnotes/2011/12/13/brown-announces-some-not-all-budget-trigger-cuts/.

[53] Legislative Analyst's Office, *The 2012-13 Budget: California's Fiscal Outlook*, November 2011, p. 3. Available at http://www.lao.ca.gov/reports/2011/bud/fiscal_outlook/fiscal_outlook_2011.pdf.

Others in government also worried about what was to come. For example, local officials who were taking state prisoners into county jails and probation systems became nervous about whether the state would continue to fund such "realignment." They pondered filing a ballot initiative to compel future realignment support (but ultimately didn't).[54] More immediately, there were concerns about the likely firing of the trigger that would produce midyear budget cuts.

Some government entities had simply assumed the trigger would be pulled and built the cuts into their fiscal year plans. Both UC and CSU announced that even with the trigger, there would be no midyear hikes in tuition since they had planned for the cuts in advance.[55] However, school districts had been ordered to assume no trigger cuts would occur in their budgets and making midyear adjustments was more difficult for them.

As it turned out, when the trigger was pulled, close to $1 billion was cut midyear. The bulk of the cuts came from education, particularly higher education, and social welfare spending. Yet the amount cut was less than half of the drop in revenue that was officially certified by the Department of Finance.[56] There may have been a public impression that having a trigger would create cuts sufficient to offset the revenue drop, dollar-for-dollar, But that was not how the process contained in the 2011-12 budget operated.

While the trigger might have been expected to be the last dramatic aftershock of the 2011-12 budget, the state Supreme Court delivered the final one. As noted earlier, local redevelopment agencies had bet their futures on a lawsuit challenging their treatment in that budget. That turned out to be a very bad bet. The Court indicated that the governor and legislature could indeed enact a provision terminating the agencies (and thus take their money). But the Court did not allow the life-saving alternative that had been enacted as a compromise, i.e., that the agencies could stay alive by making "voluntary" contributions to the state.

The agencies and their local supporters pleaded with the legislature to lift the Court's death sentence and proposals were made along those lines. But the Court had given the agencies only one month to terminate and no reprieve could be negotiated in that limited time, particularly after the governor said the "funeral" of redevelopment could not be delayed.[57] In the end, the

[54] In the end, they dropped the idea.
[55] Whatever chance there might have been for a UC tuition increase ended with an incident at UC-Davis in which "Occupy" demonstrators were pepper-sprayed by campus police. YouTube videos and internet photos circulated widely and there were explosive demonstrations at Regents meetings.
[56] The cuts were put at $980 million but the revenue gap was estimated by the Department of Finance to be $2.2 billion. Under the budget formula, the midyear forecasts of the Department of Finance and the Legislative Analyst would be compared. The gap estimate would be the *lesser* of the two and the latter's estimate was about $1.5 billion higher. Source: Letter from Department of Finance to the Legislature, December 13, 2011, available at http://www.dof.ca.gov/documents/2012_Rev_Forecast_Determination.pdf.
[57] Quoted in Micaela Massimino, "AM Alert: Deadline Looms for Action on Redevelopment Agencies," *Capitol Alert* blog of *Sacramento Bee*, January 23, 2012. Available at

abrupt death of redevelopment left the state and cities fighting over the carcasses of the defunct agencies – a process still underway at this writing.[58]

Proposing the 2012-13 Budget

"I will mix boldness with some pragmatism, so I get it done."

Governor Brown reflecting on his first year in office[59]

The California constitution requires the governor to present a budget proposal for the upcoming fiscal year to the legislature in early January. Often, hints about the budget are leaked out before the formal presentation. It was well known by January that the governor would be seeking a tax initiative in 2012 as part of his budget plan since he had submitted one.[60] But other administrative shifts and consolidations designed to save money were also leaked out.

However, the official unveiling of the budget suddenly was moved up after someone mistakenly posted a copy on the Department of Finance website only five days into the new year. The Democratic governor had some consolation over the early release; the GOP official response to his 2012 State of the State speech was somehow released online as a video *before* the governor had given it. Premature online release was at least shown to be a bipartisan failing and bipartisan displays were rare in Sacramento.

As Table 3 shows, the new Brown proposal conceded that even with the trigger cuts announced in December 2011 and with new midyear cuts that were part of his January plan, the ongoing 2011-12 fiscal year would end with a negative reserve in the -$3 billion range. Even with a successful tax initiative in November 2012 (which would produce some revenue attributable under accrual accounting to 2011-12), the reserve at the end of 2011-12 would be negative. And for fiscal 2012-13, the trigger concept would be renewed. This time, however, the trigger would be pulled if voters did not approve the tax initiative. That feature would fulfill the governor's 2010 campaign promise that there would be no new taxes without a vote of the people.

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http://blogs.sacbee.com/capitolalertlatest/2012/01/am-alert-deadline-looms-for-action-on-redevelopment-agencies.html.

[58] At issue is paying off ongoing commitments and bonds of the former agencies. There was a rush to make commitments when the idea of terminating agencies first surfaced. The state and local governments were left to feud over what commitments were real once the agencies were killed by the state Supreme Court.

[59] Quoted in John Myers, "Brown Interview: Pensive, Upbeat, More Latin," *KQED Capital Notes*, December 27, 2011. Available at http://blogs.kqed.org/capitalnotes/2011/12/27/brown-interview-pensive-upbeat-more-latin/.

[60] Because of a typo, a second version was submitted to the Attorney General's office on January 13, 2012. As will be seen below, a more major modification had to be submitted later.

The new proposal also represented another deviation from the prior year. When Brown formulated his first budget a year before, he also had a tax proposition in mind (which was thwarted when the GOP would not go along). At that time, he could have presented two budgets, one with and one without voter approval of his then-proposed tax plan. But he presented only a budget proposal containing the tax plan (that ultimately morphed into the actual 2011-12 budget with phantom revenue and partial trigger cuts). He never presented a "budget from Hell" assuming both reasonably forecast revenue and voter rejection. This time, however, there was an element of the budget from Hell in that specific cuts were spelled out in the event of voter rejection. And the cuts spelled out were heavily in education including K-12 – an area which California voters have always seen as a priority.

Given the new strategy and voter priorities, there were some risks in linking the tax initiative to potential cuts in school spending, albeit cuts that could be avoided with a "yes" vote. The tax initiative would have to be sold as protecting schools but would be seen as somehow connected to school cuts. Not surprisingly, early polling suggested opposition to school trigger cuts.[61] There would be at least one other tax measure on the ballot, the so-called Molly Munger initiative, which raised money earmarked for schools, debt repayment, and early childhood programs and had adequate financing – from Munger's personal wealth – for a full-fledged campaign.[62] There would also be the union-opposed "paycheck protection" initiative on the ballot that would be diverting union campaign money that might otherwise support the Brown tax plan.

Apart from the overall dollar inflows and outflows projected in the budget, Brown incorporated potentially important policy changes. Included were proposals to change the basic formula for funding K-12 away from average daily attendance and away from various categorical programs to weighted amounts per student. The weights would depend on such things as low-income background and English-language proficiency of students. Such reforms have long been advocated by educational experts. But the governor also proposed delaying the start of a new transitional kindergarten program that was otherwise due to start in the fall of 2012.[63] And in the juvenile criminal justice area, the state's youth prison facilities would be eliminated in favor of facilities run by local authorities. In welfare spending, the time limit for a recipient to find work would be reduced.

[61] The cuts would not be in the initiative itself since a rejected initiative is just that – rejected. It cannot dictate what happens if it is voted down. The cuts would be in the budget and enacted by the legislature, not the voters. Poll results suggesting resistance to school trigger cuts but support for the governor's tax plan (even though the two were connected in the actual plan) can be found in Public Policy Institute of California, "January 2012: Californians & Their Government," January 24, 2012. Available at http://www.ppic.org/content/pubs/survey/S_112MBS.pdf.

[62] The Munger initiative increased personal income tax revenues in the upper brackets from 2013 through 2024. The increase was estimated by the legislative analyst to bring in $5 billion in 2012-13 and $10 billion the following year.

[63] The program was ultimately put into effect.

For the three segments of higher education (UC, CSU, community colleges), Brown proposed a long-term (multiyear) funding plan in exchange for certain outcome improvements.[64] Exactly what these improvements were to be was unclear. Given past cuts, enrollments at UC and CSU (acceptances and actual attendance as opposed to admissions) as a proportion of new high school grads have been declining with some students diverting to community colleges where they then met course shortages.[65]

But there are two problems with a long-term plan. First, even if the legislature went along for 2012-13, it could not bind future legislatures and future budgets, particularly given the short memories that term limits entail. Second, the legislative analyst tends not to be keen on proposals that seem to limit legislative discretion which a multiyear commitment – even if not legally binding – seems to do. And the legislature puts significant weight on the opinions of the legislative analyst.[66] In short, long-term plans for higher education seemed not to be on the legislative agenda.[67] Gubernatorial proposals for cuts in Cal Grants – the state higher education scholarships – were met with little legislative enthusiasm and were largely rejected (although elements of these cuts remained in the eventual budget).

The budget proposal also became intertwined with environmental concerns. Under a Schwarzenegger-era law, California was due to operate a "cap and trade" program under which pollution emitters would buy permits up to a ceiling for emissions through an auction process. The governor estimated that $1 billion in revenue would accrue to the state and could be used for environmental programs. Some of the inflow of revenue could in effect fund existing environmental programs, thus freeing money for other purposes in the general fund. But the revenue, to qualify as a fee rather than a tax, would have to be spent on programs that were sufficiently close to the activity being regulated, raising some legal issues about the budget proposal.

Finally, what the budget proposed to cut – even items that would not result in reduced services – had complicated indirect effects. By law, the state must pay local governments for any services that it mandates. However, some of these services would be provided by the locals

[64] Community colleges were especially hard hit by the ongoing budget crisis and had limited ability to raise alternative sources of funding. A proposal by Santa Monica College to ease course rationing by creating additional sections of high-demand courses at higher prices for those willing to pay was met with opposition, including from the state, and was eventually killed. But the result was that fewer courses net were offered.

[65] Hans Johnson, *Defunding Higher Education: What are the Effects on College Enrollment*, Public Policy Institute of California, May 2012. Available at http://www.ppic.org/content/pubs/report/R_512HJR.pdf.

[66] Legislative Analyst's Office, "The 2012-13 Budget: Analysis of the Governor's Higher Education Proposal," February 8, 2012. Available at http://www.lao.ca.gov/analysis/2012/highered/higher-ed-020812.pdf.

[67] Within the University of California, the ongoing budgetary squeeze provoked calls for greater autonomy at some campuses, notably Berkeley and San Francisco. At UCLA, a battle was fought within the Academic Senate over making the MBA program "self-supporting" (the word "privatization" is avoided), and ultimately the self-supporting plan was approved at the campus level and later blocked at the systemwide level.

in any case, mandate or not. So removing the mandate saved the state money but did not directly cut services where the mandate was superfluous.

Still, there are two less obvious impacts of dropping redundant mandates. First, the local governments were receiving funds for the mandates that they no longer would receive if the mandates ended. So while they might not cut back on a specific mandated activity once the mandate for it is lifted, the locals would have less revenue in total and might cut back elsewhere. In addition, reducing the state's general fund by cutting mandates reduces the state's immediate and/or longer-term funding obligation for schools and community colleges under Prop 98's requirements for K-14 funding.

There was always the chance that some mandates might turn out not to be redundant, i.e., that the local governments would cease performing the function. For example, one proposed mandate elimination ended a requirement that animal shelters not euthanize strays for an extended period. Animal lovers, led by former state senator Tom Hayden, pleaded with Brown to think about his own dog Sutter (often trotted out by the governor to public events), before removing that mandate. In short, some mandates had significant political support.

The fact that the governor proposes a budget does not obligate the legislature to enact it. And to the extent the budget has complicated policy elements – such as changes in educational, incarceration, welfare, and environmental programs – the legislature is likely to want to take its time. In addition, there are always uncertainties about forecast revenues, particularly because of the state's heavy dependence on income tax receipts from high-income earners. Such earners' taxable incomes are often linked to the stock market and capital gains and the Facebook initial public offering (IPO) was beginning to loom in Sacramento's consciousness. Depending on how that IPO went, there could be a perceptible rise in tax receipts.

Senate president Darrell Steinberg said the midyear cuts being proposed for the ongoing 2011-12 fiscal year were "premature."[68] And the legislative analyst thought the revenue projections associated with the proposed tax initiative were too high.[69] More generally, the legislature typically awaits the opinions of the legislative analyst and after the budget proposal was unveiled in January 2012, the analyst provided detailed reviews of many different aspects of the budget in a stream of online publications. In short, the legislature had many reasons – a whole menu in fact – to postpone quick action.

[68] Quoted in Dan Walters, "Let the California Budget Games Begin," *Sacramento Bee,* January 6, 2012. Available at http://www.sacbee.com/2012/01/06/4166643/dan-walters-let-the-california.html.

[69] Legislative Analyst's Office, "The 2012-13 Budget: Economic and Revenue Update," February 27, 2012. Available at http://www.lao.ca.gov/analysis/2012/update/economic-revenue-update-022712.pdf.

Considering the Budget

"It is said that the road to hell is paved with good intentions and digging ourselves into a deep financial hole – to do good – is a bad idea. In this time of uncertainty, prudence and paying down debt is the best policy."

Governor Jerry Brown's 2012 State of the State speech[70]

As soon as the budget was presented, there were complaints and roadblocks. The governor's tax initiative, although billed as a millionaires' tax, in fact had a mix of an income tax increase at the upper end of the income scale plus a sales tax increase. Liberal Democrats didn't like the sales tax element because of its regressive characteristics.[71] Republicans wanted no tax increase at all. A court decision blocked the portion of the trigger cut in the 2011-12 budget that applied to home care aides.[72] Another court decision blocked cuts to Medi-Cal providers. And the Obama administration refused to go along with a plan to charge co-pays to recipients of Medi-Cal.

In addition, looming on the November ballot was a much-postponed flotation of a multi-billion dollar water project bond which seemed to contradict Brown's idea of not running up state debt. The water bond could be postponed again by the legislature – and eventually was. Court and federal decisions, however, are outside the reach of the governor and legislature. And if the tax initiative was to be rejiggered, it could only be done by filing a new version and obtaining the needed signatures in time for placing the initiative on the November 2012 ballot.

The governor had to depend on union support for his tax initiative. The largest and most influential unions – the California Teachers Association and the Service Employees International Union – did back the initiative but another union, the California Federation of Teachers, had its own version of a millionaires' tax which could potentially wind up on the ballot in competition with the Brown plan. The alternative plan also had support from significant elements in the Democratic Party. Brown apparently was in discussions with backers of the alternative as early

[70] Available at http://gov.ca.gov/news.php?id=17386.

[71] The state income tax is progressive and highly dependent on upper-income recipients. Thus, it is quite volatile since upper-income recipients have investment related income such as capital gains. The sales tax is regressive so that when all state *and local taxes* are combined, those at the bottom of the income scale pay more as a percentage of their income than others. The combination of all taxes crudely flattens out for the top 60% of earners at around 8%. The state, however, gets more than half its general fund tax receipts from the income tax. Source: California Budget Project, "Who Pays Taxes in California?," April 2012. Available at http://www.cbp.org/pdfs/2012/120413_Who_Pays_Taxes.pdf.

[72] The legislature and the governor reversed another trigger cut in February 2012 that affected rural school district student bus service. In that case, however, the cut was financed by spreading a like amount over all school districts.

as February and hinted at some kind of deal with them, telling party officials that their "marching orders" would be coming "soon enough."[73]

As part of the negotiating process, Brown released a poll that indicated that if two similar millionaires' taxes were on the ballot, both would lose. His poll – as did others – suggested in addition that the Munger tax initiative for schools was failing to capture majority support. However, there was no indication from Molly Munger that she was ready to fold her campaign and support the governor's initiative. In fact, she indicated that there would be no folding of her self-funded campaign and that she "had the resources" and was "going to spend them."[74] Discussions continued for a time with "nice e-mail" exchanges between Munger and Anne Gust, Jerry Brown's wife, without any changes in Munger's position.[75] Indeed, the Munger campaign announced plans to give away a car each week to the top signature gatherer.

Apart from core union supporters, the governor wanted to claim – and did claim – some business support from particular firms.[76] But traditional business organizations such as the California Chamber of Commerce had not given any blessing. Obtaining such support without providing other business-sought items such as regulatory changes as part of larger deal would be difficult. The California Business Roundtable signaled that it might be open for discussions by rejecting the Munger and the rival millionaires' tax but not the governor's initiative and the California Chamber followed its lead.

Meanwhile, fellow Democrat Lieutenant Governor Gavin Newsom publicly criticized the governor's proposed budget cuts for focusing only on "solvency" while lacking "a vision for greatness."[77] The Lieutenant Governor of California has relatively little responsibility – "It's so dull," Newsom said of his time in Sacramento at one point and so may have had more time for developing great visions than the governor.[78] In any event, and not surprisingly for a budget based in part on phantom revenue, the state's solvency was in question. The state controller

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[73] Quoted in David Siders, "Jerry Brown Sidesteps Taxes, Says 'Marching Orders' Coming," *Capitol Alert* blog of *Sacramento Bee*, February 11, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/02/jerry-brown-sidesteps-taxes-says-marching-orders-coming.html

[74] Quoted in John Myers, " 'Whatever it Takes,' Says Munger on Campaign," *KQED Capital Notes*, March 2, 2012. Available at http://blogs.kqed.org/capitalnotes/2012/03/03/whatever-it-takes-says-munger-on-campaign/.

[75] Quoted in David Siders, "Jerry Brown: Munger Sent 'Nice E-mail,' But No Deal in Works," *Capitol Alert* blog of *Sacramento Bee*, March 20, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/03/jerry-brown-oil-company-still-supportive-of-tax-measure.html.

[76] Firms operating in industries that might be targeted for specific taxes (oil, liquor, soft drinks) if the governor's general tax initiative failed contributed to the governor's tax initiative campaign defensively. Other firms which rely on goodwill in Sacramento also contributed. And, of course, there were contributions from labor unions. See Anthony York, Gov. Jerry Brown Lines Up Unusual Allies on his Tax Hike Initiative," *Los Angeles Times*, August 27, 2012. Available at http://www.latimes.com/news/local/la-me-proposition30-20120827,0,684082.story.

[77] Quoted in David Siders, "Gavin Newsom Suggests Jerry Brown Lacks 'Vision for Greatness,'" *Capitol Alert* blog of *Sacramento Bee*, February 1, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/02/gavin-newsom-suggests-jerry-brown-lacks-vision-for-greatness.html.

[78] Quoted in Tim Murphy, "Quote of the Day: 'I Just, Ugh, God,'" *Mother Jones*, May 29, 2012. Available at http://www.motherjones.com/kevin-drum/2012/05/quote-day-i-just-ugh-god.

warned of a cash crisis and issuance of IOUs if the legislature didn't give him permission for additional internal borrowing from funds outside the general fund – which it did.

Another fellow Democrat, California State Superintendent of Public Instruction Tom Torlakson, seemed to endorse the governor's tax initiative and maybe the rival millionaires' tax and the Munger tax, too. But he said having a trigger that would cut school budgets if the governor's tax didn't pass was "blatantly unfair."[79] Only the governor's tax plan was tied to such triggers so Torlakson's enthusiasm for Brown's proposal among the others seemed soft.

In mid-March, a compromise deal was reached with the California Federation of Teachers – sponsor of the rival millionaires' tax – and the governor, apparently with legislative leaders acting as mediators. The result was a new initiative that blended to the two, with less of an increase in the sales tax (a quarter of a cent increase instead of half a cent) and a larger upper bracket income tax increase than the governor had wanted.[80] However, starting with a new initiative at that point meant abandoning the signature drive for the previous version and starting anew with another drive. Apart from the cost – and a significant premium to signature gatherers would have to be paid – there was by then only very limited time to acquire the necessary signatures and to meet the deadline for appearing on the November budget. With what appeared to be especially rapid treatment by the Attorney General and the Secretary of State, however, the new compromise tax initiative did ultimately meet the deadline and was certified.

While the compromise on the initiative was good news for the governor, the CalPERS pension system provided some bad news at about the same time. It cut its expected long-term earnings forecast from 7.75% to 7.50% which had the effect of raising pension costs to the state (and to localities that were part of CalPERS).[81] And the legislative analyst continued to have a lower estimate that the governor of how much the tax initiative would raise: \$6.8 billion in the coming fiscal year instead of \$9 billion.[82]

Although the high-speed rail project the governor favored had little direct impact on the general fund, it became intertwined with budget discussions. The project actually goes back in planning to 1996 but voters authorized \$9 billion in bonds for the plan in 2008, despite the

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[79] Quoted in Dan Walters, "Torlakson Calls Jerry Brown's Spending Cut Triggers 'Blatantly Unfair,'" *Capitol Alert* blog of *Sacramento Bee*, March 8, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/03/torlakson-calls-browns-spending-cut-triggers-blatantly-unfair.html.

[80] The sales tax increase would apply from calendar 2013 through 2016. The income tax increases would begin in 2012 and run through 2018. Higher brackets ranging from 10.3% to 12.3% would apply to individuals earning over \$250,000 per year and joint filers earning over \$340,000. About 1% of California income tax filers would be affected by the higher rates.

[81] CalPERS provided a two-year period of adjustment to the lower rate, somewhat easing the immediate budget squeeze.

[82] Legislative Analyst's Office, "2011 Initiative Analysis: The Schools and Local Public Safety Protection Act of 2012" Version 3, March 16, 2012. Available at http://www.lao.ca.gov/ballot/2012/120208.aspx. (The title contains the 2011 date because the first version of the governor's initiative was submitted in 2011. As noted earlier, a second version with a typo correction was submitted subsequently.)

ongoing financial crisis of that period. Various plans were put forward but the overall budget for the project went as high as $100 billion before Governor Brown installed new leadership into the entity in charge of planning and lowered the estimated cost to $68 billion. Even so, there is a big gap between what voters authorized, what the federal government seemed willing to chip in initially (about $3.5 billion), and the estimated cost which would ultimately have to be filled by passenger receipts and other sources. (The governor proposed that cap-and-trade revenues might be used.) The legislative analyst showed considerable skepticism about the project and opponents of the governor's tax initiative often cited it as an example of wasteful state spending.[83]

Apart from the high-speed rail issue, there were other aggravating factors that tended to undermine the case for the legislative majority to rally around the governor's budget. Salaries paid to new CSU campus presidents became an issue, in part because of rising tuition, course rationing, the threat of withholding certain graduate tuition grants (ultimately reversed), and limits on new enrollments. Legislative Republicans proposed cutting pay of state workers and a host of other cuts Democrats would not accept in place of the tax initiative. In addition, the budget-linked realignment plan moving state prisoners to county jails and parole supervision ran into criticism in LA County where some parolees disappeared.

Prelude to the May Revise

"It's just March; it's just March."

Senate President Darrell Steinberg
explaining limited progress on the budget[84]

"…(T)he legislature has to man up, make the cuts, and get some taxes and we'll make it."

Governor Brown during a radio interview[85]

By the end of March and early April, the governor was clearly becoming impatient with slow progress in the legislature in making cuts, particularly since there were indications – again, not surprisingly in a budget built partly on phantom revenue – that forecast revenues were not arriving as projected. However, he conceded that, given the normal process under which the

[83] Legislative Analyst's Office, "The 2012-13 Budget: Funding Requests for High-Speed Rail," April 17, 2012. Available at http://www.lao.ca.gov/analysis/2012/transportation/high-speed-rail-041712.pdf.
[84] Quoted in Kevin Yamamura, "California Legislative Democrats Balk at Jerry Brown's Budget Cuts," *Sacramento Bee*, March 27, 2012. Available at http://www.sacbee.com/2012/03/27/4368814/california-legislative-democrats.html.
[85] Quoted in David Siders, "Jerry Brown Tells Legislature to 'Man Up,' Make Cuts," *Capitol Alert* blog of *Sacramento Bee*, April 13, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/04/jerry-brown-tells-legislature-to-man-up-make-cuts.html.

governor presents a May Revise of the budget, "it's a little early yet."[86] By that time, however, polling suggested that there could be problems in obtaining voter support for the governor's tax initiative.

A PPIC poll indicated that 54% of "likely voters" would support the initiative.[87] But the usual folk wisdom is that prior to the actual campaign for a ballot measure, potentially controversial propositions should poll 60% support or more since some support slips once negative campaigning begins. And there would be two sources of negative campaigning. First, there would be the usual anti-tax groups. Second, supporters of the Munger tax might well denounce the Brown initiative as inferior.

By early May, the Munger petitions were being handed in to the Secretary of State. At about the same time, Brown declared he had sufficient signatures for his tax plan, too. Signatures were also being turned in for a third "Steyer" tax initiative that would close what proponents viewed as a corporate tax loophole with a little over half the money raised going for energy efficiency projects.[88] (Thomas Steyer, the initiative's sponsor, is a wealthy California hedge fund manager.) So there would be three tax measures on the November ballot along with initiatives on other subjects.

Looming on the June 2012 ballot was a potential earlier test of voter willingness to enact new taxes. Prop 29 would impose a new tobacco tax with the money raised earmarked for cancer research. Since most voters are not smokers and since curing cancer is inherently appealing, voter rejection of Prop 29 would signal voter resistance to any kind of tax. Health advocates supported the measure (including New York Mayor Michael Bloomberg). But there was bound to be significant funding for a "no" vote campaign financed by tobacco companies.

Could a well-financed campaign defeat a "sin tax" that had inherent appeal to many voters? If so, a less-well-funded opposition campaign for a more controversial tax – such as the

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[86] Quoted in David Siders, "Jerry Brown Says Budget Gap Could Grow by $1 Billion or More," *Capitol Alert* blog of *Sacramento Bee*, April 17, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/04/jerry-brown-says-budget-gap-could-grow-by-1-billion-or-more.html.

[87] Public Policy Institute of California, "April 2012: Californians and Education," April 2012. Available at http://www.ppic.org/main/publication.asp?i=1014.

[88] Under the Steyer initiative, out-of-state firms would not have the option of using either of two alternative tax treatments and would have to base their tax only on one of the options, the proportion of their sales in California. The two-option system arose from a budget deal during the Schwarzenegger era. The legislative analyst estimated the change in tax treatment would raise about $1 billion annually. The Steyer initiative earmarked revenue for energy efficiency. An alternative bill in the legislature would have made the same tax change but earmarked revenue for tuition reduction at public universities. That version would have required a two-thirds vote in the legislature. It passed in the assembly but failed in the state senate.

governor was advocating – might succeed. As the negative campaigning began, support for the tobacco tax dropped from 67% in March to 53% in May, according to the PPIC poll.[89]

Whatever the fate of the tobacco tax, what did seem unlikely in June was a repeat of a gubernatorial veto of whatever budget the legislature did finally pass, as had occurred in the prior year. That episode was the result of gubernatorial insistence on trying to negotiate a deal with GOP legislators to the point that the Democratic majority panicked that the June 15 deadline would pass and they wouldn't be paid. This time, however, there was no need for panic since the GOP was essentially a bystander on the budget and the governor had no incentive to seek Republican cooperation. The initiative route would take care of putting a tax hike on the ballot. And only a majority – which the Democrats had – was needed to pass a budget. On national television, Governor Brown referred to the GOP as stuck in "a reactionary cul-de-sac" that "takes on the quality of a cult."[90]

Moreover, it was less likely that the controller would rule that whatever budget passed did not meet technical requirements and refuse to issue paychecks. A court had ruled that the legislature, not the controller, would decide whether whatever budget it enacted passed muster.[91] However, there still was a need for the governor and the legislature to reach an agreement for a budget to be in place by July 1, 2012.

The 2012 May Revise

"The state employees particularly have come forward with some very imaginative ideas. They've been willing to step up to the plate."

Governor Jerry Brown commenting on the quasi-furloughs for state employees proposed in his May Revise budget[92]

"We're not some tired country of Europe."

Governor Brown pointing to the state taking corrective action on its budget through his May Revise budget cuts, his ballot initiative, and proposed his infrastructure plans[93]

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[89] Public Policy Institute of California, "May 2012: Californians and Their Government," May 2012. Available at http://www.ppic.org/main/publication.asp?i=1019.

[90] Quoted in Leigh Ann Caldwell, "Jerry Brown: GOP Must Move Out of Their 'Reactionary Cul-de-Sac,'" *CBS News*, April 29, 2012. Available at http://www.cbsnews.com/8301-3460_162-57423835/jerry-brown-gop-must-move-out-of-their-reactionary-cul-de-sac/.

[91] The controller eventually appealed the court decision and might have refused to issue paychecks, setting up a legal tussle. But since the legislature was unlikely to pass a panicked budget, the technical deficiencies that the controller cited the year before would probably not arise.

[92] Quoted in Jon Ortiz, "California State Workers May Face Shorter Workweeks, Less Pay," *Sacramento Bee*, May 15, 2012. Available at http://www.sacbee.com/2012/05/15/4490008/california-state-workers-may-face.html.

As noted in the earlier discussion of accounting procedures in the state, it is difficult (apparently impossible) to reconcile the cash flow data with the official accrual-based budget data. We know that in the end, the 2011-12 year on a cash basis finished with over $4 billion less in receipts than had been budgeted, an amount roughly corresponding to the phantom revenue assumed in June 2011 to pass the budget by majority vote. (Table 2) All we can say is that when the May Revise was presented (Table 3), there was little difference between the January depiction of what the governor said would happen in 2011-12 and what he said would happen in that year as of May. If his tax initiative passed in November 2012, there would be some accrued tax liability during 2011-12 which would boost revenues. Even with that added amount, he was short in that year by close to $4 billion (because the reserve at the end of the year would be -$2.5 billion instead of +$1.3 billion that the original budget projected.

Most of the problem to be dealt with in the May Revise, however, was in the coming year which the governor addressed partly with his proposed tax initiative which he assumed in the budget would pass. Since the Facebook IPO had not been factored into the January estimates for 2012-13, but was factored in by the May Revise, there was a "new" assumed increment of $1.5 billion in income taxes for the coming fiscal year. If the tax initiative did not pass, there would be trigger cuts of a little over $6 billion. The bulk of those cuts would come from K-14 ($5.5 billion) and the rest from higher education ($0.5 billion) plus a scattering of other programs. Various other cuts were made, trigger or not, primarily in social welfare spending.

There would be a $400 million saving in the general fund (plus a similar amount in funds outside the general fund) by reductions in state employee pay which would have to be negotiated with unions. The governor came up with an elaborate plan for rescheduling work hours to a four-day, 38-hour week (with less pay due to the hours reduction). It appeared that this elaborate plan was mainly to differentiate what the governor was proposing from simpler Schwarzenegger-era furloughs.

However, going to a four-day work would have raised a host of service delivery problems. In the end, most unions accepted simpler furloughs – although the f-word was avoided – to achieve the saving. They had a strong incentive to go along with the governor and not become involved in disputes with him that might undermine passage of the tax initiative.

The legislative analyst expressed some concerns about possibly overestimated revenue forecasts. In particular, the analyst noted that the savings to the state that resulted from the abrupt termination of redevelopment by the state Supreme Court might be less than anticipated. At the very least, there would be litigation over what was owed to the state that could delay

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[93] Quoted in "Gov. Jerry Brown says California is Not a 'Tired' European Country," *CBS News*, May 18, 2012. Available at http://www.cbsnews.com/8301-505267_162-57436905/gov-jerry-brown-says-california-is-not-a-tired-european-country/.

redevelopment receipts thanks to the sloppiness of a sudden termination of a longstanding major program in midstream.[94]

Apart from the overall numbers, the May Revise included some refinements in the governor's January plan for changing K-12 funding, reducing mandates on local governments that the state had to fund, and restricting Cal Grants. The last item, as noted in the discussion of the January 2012 proposal, was particularly unpopular with legislative Democrats, although in the end they approve some cuts which the governor sharpened via his line-item veto.

In contrast to realignment for the prisons – which emphasized the benefits of local administration – the governor moved in the opposite direction with the state court system, centralizing control and removing local discretion.[95] There was also consolidation within state government through consolidating certain agencies and eliminating some boards and commissions. The state's Little Hoover Commission endorsed the plan, and the legislature did not disapprove it, so that the changes would become effective in 2013-14.

Despite the risks entailed in talking up expensive infrastructure projects while proposing budget cuts, Governor Brown continued to tout high-speed rail and other long-term investments such as a new state water plan. The theme of his administration of the 2010s, in contrast to that of the Jerry Brown of the late 1970s and early 1980s, seemed to have switched from small is beautiful to big is beautiful – at least in the context of long-term growth. While a focus on the Big Picture by the governor posed political risks, it at least obscured the tendency of the legislature to become involved in minutiae. On May 25, for example, the state senate proclaimed that May was to be California Beer Distributor Month. Shortly thereafter, the state panel that sets the pay of legislators and other elected state officials, cut their pay by 5% citing the ongoing budget problems.

Budget Enactment

"I'd run for governor whether it was a paid job or not. I derive a lot of psychic income."

Governor Jerry Brown commenting on his 5% pay cut[96]

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[94] Legislative Analyst's Office, "The 2012-13 Budget: Overview of the May Revision," May 18, 2012. Available at http://www.lao.ca.gov/reports/2012/bud/may_revise/overview-may-revise-051812.pdf.

[95] There had been an ongoing, and very public, dispute between some in local court administration and the chief justice of the state Supreme Court (who is also the chief court administrator) concerning centralization vs. autonomy. The governor came down on the side of centralization, mainly for budget reasons rather than some grand philosophy of management. Local courts had maintained local cash reserves which the governor proposed to use to offset other cuts in the court budget.

[96] Quoted in Torey Van Oot, "Jerry Brown on Pay Cut," *Capitol Alert* blog of *Sacramento Bee*, May 31, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/05/jerry-brown-on-pay-cut-i-derive-a-lot-of-psychic-income.html.

As the legislature was debating the May Revise proposal of the governor, which included the assumption that his tax initiative would pass, the June 5 primary contained some inauspicious information. The tobacco tax proposition – despite its early favorable polling – was narrowly defeated with 50.2% voting "no."[97] Meanwhile, as the June 15th deadline for legislative enactment of a budget loomed (with the threat of no pay for every day it was late), there was a flurry of back and forth communications – some public, some undoubtedly private – over what the governor would accept.

The differences between the legislative majority and the governor were over his proposed social welfare cuts. While in theory the legislators could have passed a budget unacceptable to the governor and yet met their constitutional obligation, such a development and impasse might have undermined public support for the tax initiative. What occurred was a budget enacted in pieces.

On June 15th, an incomplete plan was sent to the governor while discussions continued. There appeared to be differences between the leadership in the senate and assembly as to their respective positions. The state controller in principle might have tested the court decision indicating he lacked the power to withhold legislators' pay – but he didn't – allowing the three-way talks to continue.[98] Six days later, a "conceptual" deal was reached involving greater cuts in CalWorks ("welfare") than the legislators had wanted. In the interim, and with a speed one observer satirically termed a "miracle," the governor's tax initiative was officially certified for the November 2012 ballot by the Secretary of State.[99] It was later disclosed that the governor had phoned at least one county election official to make what a spokesperson called a "friendly inquiry" about how the counting was going.[100]

Once the outlines of the 2012-13 budget deal were announced (and even before a final deal was approved), complaints began over the specifics. There was vocal opposition to a proviso ending the "Healthy Families" program of health insurance for children of the working poor and merging it into the larger Medi-Cal program. Opponents of the shift worried that because of the low payments to health providers under Medi-Cal, there could be access problems

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97 A partial recount requested and paid for by a proponent of the proposition in Los Angeles County did not reverse the loss.

98 The controller waited until the new fiscal year began and then filed an appeal of the earlier court decision saying he had no power to withhold legislative pay, as he had done in 2011.

99 The signatures for the revised version of the governor's tax initiative were turned in sufficiently late so that there was a danger they would not meet the deadline for the November ballot. However, the verification process seemed "miraculously" expeditious. See Joe Mathews, "Jerry's June 20 Miracle," *Fox and Hounds*, June 25, 2012. Available at http://www.foxandhoundsdaily.com/2012/06/jerrys-june-20-miracle/. Mathews noted that the governor's initiative was certified before the other two tax initiatives that also ended up on the November ballot even though the petitions for those two were handed in earlier.

100 Quoted in Anthony York, "Did Jerry Brown Pull Rank to Get Petition Signatures Processed?," *Los Angeles Times*, July 1, 2012. Available at http://www.latimes.com/news/local/la-me-jerry-brown-20120701,0,177012.story.

for the affected children.[101] UC and CSU officials complained that the deal reportedly contained a last-minute feature that would cut their budgets if there were tuition increases (assuming the governor's initiative passed).[102] A last-minute bill provided an additional tool to aid the state in its battle with local governments over revenue from the corpse of the defunct redevelopment agencies. The state was given the power to withhold sales and property tax receipts that would otherwise flow to the locals if they resisted the state's interpretation of what it was owed.

The actual budget bill signing took place on June 27, three days before the new fiscal year. However, along with the signing came line-item vetoes which, for the general fund, reduced spending by $129 million. The vetoes decreased Cal Grants for certain private school higher ed students, reduced spending on selected programs for young children, and cut funding for a K-12 college readiness program.

Who's on First?

"This attempt to change the rules in the middle of the game is a manipulation of the political process…"

Spokesperson for Molly Munger concerning various procedures that put the governor's initiative first on the November ballot and ahead of the Munger initiative[103]

A combination of three actions put the governor's tax initiative in first place – as Proposition 30 – on the November ballot. As noted earlier, there was the "miracle" by which the initiative was certified before others whose petitions had been handed in earlier. In addition, the legislature passed a bill declaring that bond issues should go first on the ballot (knowing it would soon yank the one November bond issue from the ballot) and that constitutional amendments – such as Brown's – would go next. Normally, such a bill could not take effect in time to affect the November ballot but budgetary "trailer" bills have an exception and go into effect immediately. So the legislature included a $1,000 appropriation in the bill, thus invoking the budget trailer exception.

Folk wisdom has it that ballot propositions that appear first have a better chance of approval than those lower down. And there is some evidence for that view based on the order in which candidates appear. Candidates appearing first have a better chance than others, according

[101] Some advocacy groups, however, argued that Medi-Cal in principle provided more services than Healthy Families (assuming, of course, that access was available).
[102] UC later committed itself not to raise tuition. CSU officials were less committal.
[103] Quoted in Kevin Yamamura, "Brown Rival Sues to Block His Tax Measure from Ballot Top," *Capitol Alert* blog of *Sacramento Bee*, June 28, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/06/molly-munger-anti-tax-groups-considering-lawsuits-on-california-ballot-bill.html.

to some research.[104] While some observers might be offended by the tactics used to put the governor's initiative first, Governor Brown has not been a milquetoast when it comes to the political process. As attorney general, he refused to take action when then-Governor Schwarzenegger pushed to obtain his way on some legislation. Brown observed back then that the process of politics was not one of "doilies and tea."[105]

Molly Munger was offended by the process, however, and filed a lawsuit against the ballot ordering on behalf of her initiative, alleging misconduct by county officials involved in signature verification. A lower court temporarily blocked the numbering at one point. Eventually, however, Munger dropped her suit. The Howard Jarvis Taxpayers Association continued with its own lawsuit on the issue of ballot ordering but with no success at this writing. And as the clock ran, it became difficult to change ballot materials. So the governor's tax initiative remained on top as Prop 30.

Munger's school-oriented tax became Prop 38. The third Steyer tax initiative aimed at closing a corporate tax loophole became Prop 39. Another budget-related proposition – Prop 31, supported by a business-oriented political reform group – would change the overall state fiscal process, notably by switching to a two-year budget cycle and by giving the governor to make certain spending cuts during fiscal emergencies. The other propositions on the ballot did not directly deal with taxes or budgeting. However, Prop 32 – a so-called "paycheck protection" GOP-supported initiative – would ban use of union dues for political purposes. Since defeating Prop 32 was seen as a life-or-death matter by labor unions, it had the potential to divert union funding that would otherwise go to supporting the governor's tax initiative.

Pensions, Trains, and Parks

"The governor has a hybrid (pension) concept but does not have a fleshed-out proposal."
Senate president Darrell Steinberg[106]

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[104] See Marc Meredith and Yuval Salant, "On the Causes and Consequences of Ballot Order Effects," undated working paper (2012?), Department of Political Science, University of Pennsylvania. Available at http://www.sas.upenn.edu/~marcmere/workingpapers/BallotOrder.pdf.

[105]Quoted in Torey Van Oot, "Brown Not Troubled by Schwarzenegger's Veto Threats," *Capitol Alert* blog of *Sacramento Bee*, October 9, 2009. Available at http://blogs.sacbee.com/capitolalertlatest/2009/10/brown-says-schw.html.

[106] Quoted in Kevin Yamamura, "Steinberg: Jerry Brown Has Pension Concept But No Proposal," *Capitol Alert* blog of *Sacramento Bee*, July 3, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/07/darrell-steinberg-jerry-brown-has-california-pension-concept-but-no-proposal.html.

"Here you have an unpopular, multibillion-dollar long-term project kind of rearing its head in the middle of this budget cutting. ...(T)hat's really what's jeopardizing the Brown (tax) measure."

Pollster Mark DiCamillo[107]

"The department has been going around telling people we had to close parks and it comes to light we had been sitting on this kind of money... This is the worst violation of the public trust that one could imagine."

Retired parks official commenting on the discovery of "hidden" funds at the California Department of Parks and Recreation[108]

As the summer began, there were promises that the legislature would enact some kind of public pension bill before the end of August. From the governor's viewpoint, obtaining a pension deal would enhance the chances of voter approval for his tax initiative. Exactly what the legislature might enact on pensions and what the governor would accept was unclear.

Polls suggested the governor's high-speed rail plan was unpopular and might decrease those chances. It was uncertain, however, whether voters linked the two issues, other than when pollsters did it for them. Nonetheless, the legislature needed to authorize initial construction for the project if it were to proceed. Approval to begin building the rail line squeaked through the legislature early in July, as far away in time from the November ballot as possible.

Although the high-speed rail issue was recognized early as something to deal with and move on, an unexpected scandal regarding state parks was not anticipated. During the ongoing budget crisis, there had been repeated threats of state park closures. An attempt was made in 2010 to enact an initiative that would have added to park funds through a motor vehicle fee hike, but voters rejected it. As the threat of closures unfolded, various local government and private groups engaged in fundraising to keep their parks open. It was then discovered that the Department of Parks and Recreation had $54 million in "hidden" funds on hand, a discovery that led to the resignation of the Department's head and the firing of the second in command.

While amounts in the millions of dollars won't solve state budget problems in the billions, the distinction in magnitude can easily be lost in public perceptions. There was fear that the parks scandal could undermine the governor's message that more tax money was needed by

[107] Quoted in David Siders, "Rail Vote Potential Pitfall for Gov. Jerry Brown's Tax Initiative, Field Poll Finds," *Sacramento Bee*, July 5, 2012. Available at http://www.sacbee.com/2012/07/05/4610612/rail-vote-potential-pitfall-for.html.
[108] Quoted in Matt Weiser, "Hidden California State Parks Funds Spark Outrage," *Sacramento Bee*, July 21, 2012. Available at http://www.sacbee.com/2012/07/21/4646682/hidden-parks-funds-spark-outrage.html.

the state. Opponents of tax increases added the new scandal to pensions and high-speed rail as reasons to reject the governor's initiative. Legislative and other investigations were begun of the parks situation. The governor tried an optimistic approach saying it was better to discover you haven't spent all your money than to discover you had spent what you didn't have.[109]

The parks scandal continued during the summer of 2012 and it appeared that some illegal spending in the Department may also have been involved. However, there may be been a salutary effect, albeit not one for obtaining voter approval for the governor's tax initiative. The scandal pointed to the proliferation of accounts outside the general fund, to poor state information systems that did not allow managers to know in real time how much money they had or were spending, and to the apparently non-reconcilable gap – discussed earlier – between cash flows and what the legislature thinks it is allocating and receiving in the budget. If the parks situation were to lead to addressing these weaknesses that adversely affect administration and policy making, state fiscal policy could be much improved.

An Inconclusive Conclusion

*"At this stage of my life, as I see many of my friends dying – I went to the funeral of my best friend a couple of weeks ago – I want to get sh*t done."*

Governor Jerry Brown advocating a new water infrastructure plan[110]

As noted at the outset of this chapter, the California budget story has no real beginning or end. In the chapter, the story ends inconclusively in mid-summer 2012. Readers will know by the time this chapter appears in *California Policy Options* what happened to the governor's tax initiative and all the other initiatives on the November 2012 ballot. Readers will know in addition the consequences of the national elections of 2012 that could also have long-term impacts on California and its budget dilemma.

But despite the inconclusiveness, there are some take-aways from what has been covered. The California budget crisis is in immediate terms the product of the Great Recession. And the process of dealing with the aftermath of the Recession reflects the state's political institutions and their dysfunctions. Yet underlying the difficulty California has had with adjusting its budget

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[109] See David Siders, "Jerry Brown Calls Parks Scandal a 'First,' Downplays Significance," *Capitol Alert* blog of the *Sacramento Bee*, July 25, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/07/jerry-brown-calls-california-parks-scandal-a-first-downplays-significance.html.

[110] Quoted in David Siders, "Jerry Brown: 'I Want to Get S--- Done' at this Stage of Life," *Capitol Alert* blog of *Sacramento Bee*, July 25, 2012. Available at http://blogs.sacbee.com/capitolalertlatest/2012/07/jerry-brown-i-want-to-get-s----done-at-this-stage-of-life.html.

to a soft economy is a factor that appears to go back further than 2008 or even the decade of the 2000s.

From the beginning of World War II to the end of the Cold War, California experienced super-normal growth relative to the U.S. average. There were bumps in the road during that era reflecting the national business cycle. But given the long-term super-normal trend, a trend fueled by military expenditures in the state, there was generally money around for infrastructure expansion and for social programs without a need for sharp trade-offs. When the state's growth became average, public expectations for services remained stuck on the old trend line. Until the gap between expectations and reality closes, institutional reforms will help but won't fix the underlying California fiscal problem.

Table 1: General Fund Debt, Cash, and Disbursements ($ billions or percent)

Year Ending June 30	Short Term Debt*	Cash Balance	Total Cash**	Disbursements	Debt as Percent of Disbursements
End of Pete Wilson Regime					
1998	$0	$0.9	$1.0	$53.1	0.0%
1999	0	0.8	2.1	58.6	0.0
Gray Davis Regime					
2000	0	8.5	9.3	64.5	0.0
2001	0	3.4	3.6	83.5	0.0
2002	10.4	0.0	0.0	80.4	12.9
2003	11.0	0.4	3.0	78.7	14.0
First issuance of Economic Recovery Bonds***(Schwarzenegger)					
2004	0	0.5	2.8	79.6	0.0
2005	0	6.4	7.2	82.0	0.0
2006	0	9.2	10.5	91.5	0.0
2007	0	2.5	4.1	104.1	0.0
Second issuance of Economic Recovery Bonds**** (Schwarzenegger)					
2008	1.5	0.0	0.9	107.3	1.4
2009	11.9	0.0	0.0	98.2	12.1
2010	9.9	0.0	0.0	86.7	11.4
2011	8.2	0.0	0.0	93.8	8.7
Jerry Brown Regime					
2012	9.6	0.0	0.0	89.2	10.6

*Outstanding loans (external and internal).
**Differs from cash balance by Special Fund for Economic Uncertainties (a "rainy day" fund maintained for the General Fund).
***Refinanced short-term debt on a longer-term basis.
****Issuance of remaining authorized Economic Recovery Bonds allowing longer-term funding of short term debt.
Source: June cash reports of the California State Controller. Available at http://www.controller.ca.gov.

Table 2: Actual vs. Forecast Results for 2011-2012 Budget on Cash Basis ($ Billions)

	June 2011 Forecast*	Actual	Actual -Forecast Difference
Receipts	$92.2	$87.8	-$4.5
Disbursements	89.3	89.2	+.1
Surplus or Deficit	+3.0	-1.4	-4.4
End of Year Reserve	-5.2	-9.6	-4.4

*Details may not add to totals due to rounding.

Source: California State Controller, June 2012 cash statement. Available at http://www.sco.ca.gov/Files-ARD/CASH/fy1112_june.pdf.

Table 3: Budget History: 2011-12 and 2012-13 Budgets Proposed and Enacted ($ Millions)

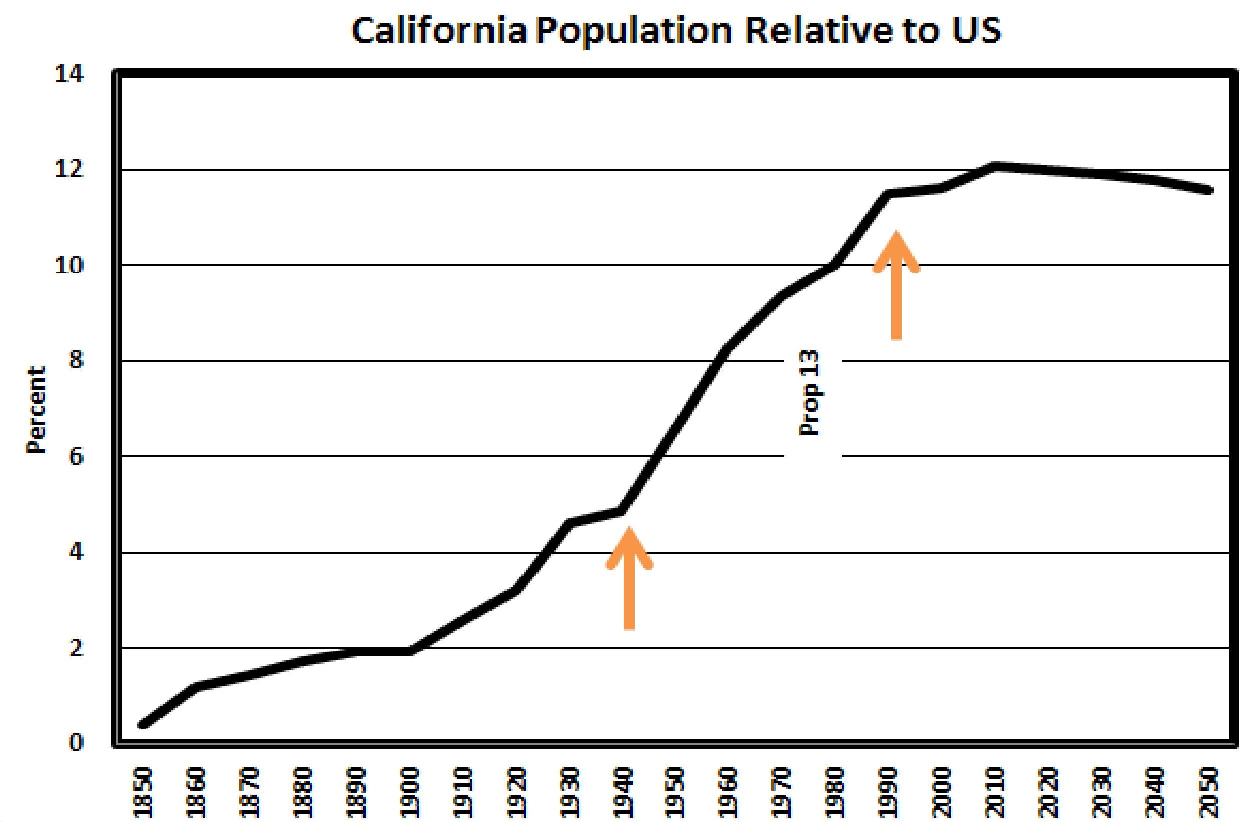
Fiscal Year 2011-12	Enacted June 2011	Reported Jan. 2012	Reported May 2012	Reported June 2012
Beginning Reserve	-$1,206	-$3,029	-$2,844	-$2,685
Revenue & Transfers	88,456	86,309	86,809	86,830
Expenditures	85,937	86,646	86,500	87,027
Surplus or Deficit	+2,519	-337	+309	-197
End Reserve	+1,313	-3,416	-2,535	-2,882

Fiscal Year 2012-13	Proposed Jan. 2012	Proposed May 2012	Enacted June 2012
Beginning Reserve	-$985*	-$2,535	-$2,882
Revenue & Transfers	95,389	95,689	95,887
Expenditures	92,553	91,387	91,338
Surplus or Deficit	+2,836	+4,302	+4,549
End Reserve	+1,851	+1,767	+1,667

*Differs from -$3,416 million shown above because assumed voter-approved tax increase is partly attributed to 2011-12 fiscal year.

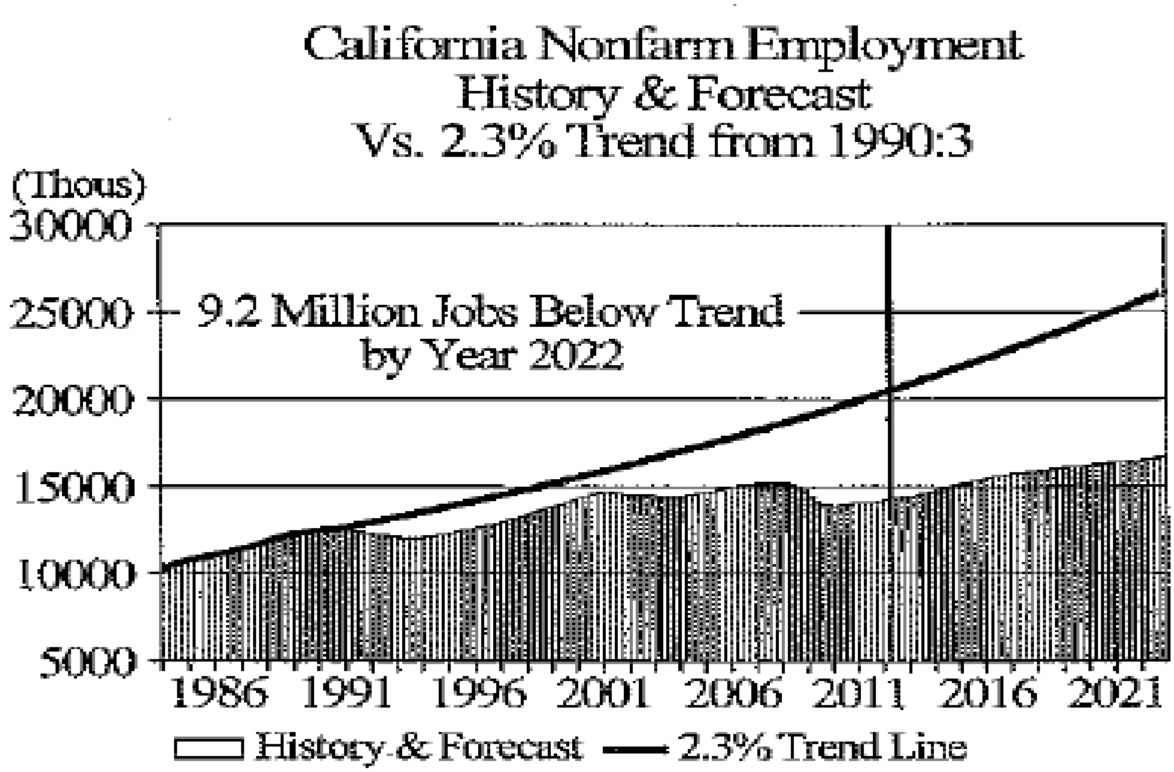
Source: California Department of Finance, budget documents. Available at
http://www.ebudget.ca.gov/BudgetSummary/BSS/BSS.html,
http://www.ebudget.ca.gov/Revised/BudgetSummary/BSS/BSS.html,
http://www.ebudget.ca.gov/Enacted/BudgetSummary/BSS/BSS.html,
http://2011-12.archives.ebudget.ca.gov/Enacted/BudgetSummary/BSS/BSS.html.

Chart 1



Source: U.S. Bureau of the Census and California Department of Finance. Projections from http://www.census.gov/population/www/projections/files/nation/summary/np2008-t2.xls and http://www.dof.ca.gov/research/demographic/reports/projections/interim/documents/Final_2012_Interim_Proj_Web.xls.

Chart 2



Source: UCLA Anderson Forecast, *The UCLA Anderson Forecast for the Nation and California: June 2012* (Los Angeles: UCLA Anderson Forecast, 2012), p. California-115.

Chart 3

Taxes as percent of personal income in study states, 2009							
	California	Illinois	New Jersey	New York	Texas	Virginia	United States
	Tax revenue as % of personal income						
State & local government tax revenue	**11.1**	**10.8**	**11.7**	**15.0**	**9.5**	**9.2**	**10.7**
State government tax revenue	6.6	5.6	6.3	7.2	4.6	4.9	6.0
Local government tax revenue	4.5	5.2	5.5	7.8	4.9	4.3	4.7
	Tax revenue as % of personal income, compared to average for all states (US=100)						
State & local government tax revenue	**104.1**	**101.3**	**110.0**	**140.5**	**89.3**	**86.1**	**100.0**
State government tax revenue	110.2	93.1	104.4	119.3	76.9	80.8	100.0
Local government tax revenue	96.3	111.9	117.3	167.8	105.3	93.0	100.0

Source: State Budget Crisis Task Force, *Report of the State Budget Crisis Task Force*, July 2012, p. 93. Available at http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf

CHAPTER 5

Clean Trucks Programs: Costs, Benefits, Effects, and Lessons from the Ports of Los Angeles and Long Beach

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This chapter is based on a term report for Public Policy 233, Winter 2012.

Nearly half of all goods imported into the United States arrive at the Port of Los Angeles or the Port of Long Beach.[1] Most of those goods are then placed on trucks.[2] Trucks often transport goods in the same intermodal containers that ships and trains use and often serve as intermediaries between ships docking at the two ports and trains transporting goods to other regions of the country. The Ports of Los Angeles and Long Beach are located adjacent to one another and share many of the same highway and rail facilities. They also combine to generate more pollution than any single facility in the country.

As the two largest ports in the United States—and the seventh largest port in the world if combined[3] (see FIGURE 1)—the Port of Los Angeles and the Port of Long Beach have enormous effects on people living and working nearby.

FIGURE 1: TOP 20 CONTAINER PORTS BY VOLUME 2010 (million TEU's)

Rank	Port, Country	2009	2010	2011 (preliminary)
1	Shanghai, China	25.00	29.07	31.74
2	Singapore, Singapore	25.86	28.43	29.94
3	Hong Kong, China	21.04	23.70	24.38
4	Shenzhen, China	18.25	22.51	22.57
5	Busan, South Korea	11.98	14.19	17.17
6	Ningbo-Zhoushan, China	10.50	13.14	14.72
7	Guangzhou Harbor, China	11.20	12.55	14.26
8	Qingdao, China	10.26	12.01	13.02
9	Dubai, United Arab Emirates	11.10	11.60	13.01
10	Rotterdam, Netherlands	9.74	11.14	11.88
11	Tianjin, China	8.70	10.08	11.59
12	Kaohsiung, Taiwan, China	8.58	9.18	9.64
13	Port Kelang, Malaysia	7.31	8.87	9.60
14	Antwerp, Belgium	7.31	8.47	8.66
15	Hamburg, Germany	7.01	7.91	9.04
16	Tanjung Pelepas, Malaysia	6.00	6.54	7.50
17	Los Angeles, U.S.A	6.75	6.50	7.94
18	Long Beach, U.S.A.	5.07	6.26	6.06
19	Xiamen, China	4.68	5.82	6.47
20	New York/New Jersey, U.S.A	4.56	5.29	5.50

SOURCE: World Shipping Council[4], formatting by author

Since the City of Los Angeles officially founded its port on the San Pedro Bay in 1907[5] and the City of Long Beach opened a competing port in 1911[6], the two ports have facilitated local and national goods movement and created local and regional jobs. By the 1930's trucks were responsible for 65% of intra-state goods movement to and from the ports.[7] But they also produced (mostly) local pollution. Smog and haze were prevalent around the San Pedro Bay in 1921.

Today the problems of smog and haze have been alleviated considerably and the ports continue to deliver economic benefits to the region. But less visible pollution is a major issue. For the past 70 years, most trucks entering and exiting the ports have been powered by heavy duty diesel engines. These engines are particularly harmful to human health because they emit high levels of diesel particulate matter, oxides of nitrogen, and other air pollutants. Particulate matter is not visible to the human eye but it is responsible for 70% of the known cancer risk from exposure to toxic air in Southern California.[8]

Because of negative health outcomes documented near the ports and pressure from regional, state, and federal regulators, the Port of Los Angeles and the Port of Long Beach created the San Pedro Bay Ports Clean Air Action Plan in 2006.[9] A key element of the plan was for each port to create a Clean Trucks Program that would reduce pollution by 80% while encouraging job creation and economic growth. This chapter evaluates the effects each program has had on residents and workers around the San Pedro Bay and provides a framework for successful Clean Trucks Programs in the United States.

Motivations for Clean Trucks Programs

Multiple studies have proved that air quality around the Port of Los Angeles and the Port of Long Beach is poor, especially near the 710 freeway, the 110 freeway, and heavily traveled freeway access roads (see FIGURE 2). Ultrafine particulate matter has been measured at dangerous levels within 500 meters of roadways heavily trafficked by trucks[10], people who live near these roadways are significantly more likely to suffer from respiratory illness than people who do not[11], and heavy duty diesel trucks contribute up to 70% of all particulate matter pollution in California.[12] Residents and workers around the ports demand improved air quality through complaints and lawsuits.

Before the Clean Trucks Programs were implemented, most trucks serving the ports were powered by heavy duty diesel engines and many of the trucks were 20 to 30 years old. Frequently, when heavy duty diesel trucks were no longer capable of servicing long trips or could not pass environmental muster for interstate trips, they were put into use shuttling goods short distances to and from ports.[13] At the San Pedro Bay ports, most of the oldest, heaviest polluting trucks were owned by individuals who were paid to transport loads short distances to rail yards and other distribution centers.

Technology advancements have made it possible to rehabilitate old dirty trucks and produce new clean trucks. Devices like diesel particle filters and selective catalytic reduction systems can be installed on old trucks at significant cost or built into new clean trucks for comparatively less money.[14] New clean trucks can also be powered by liquefied natural gas. Rehabilitating old trucks can considerably reduce dangerous particulate matter pollution, while replacing old trucks with clean trucks reduces pollution by up to 90%.[15]

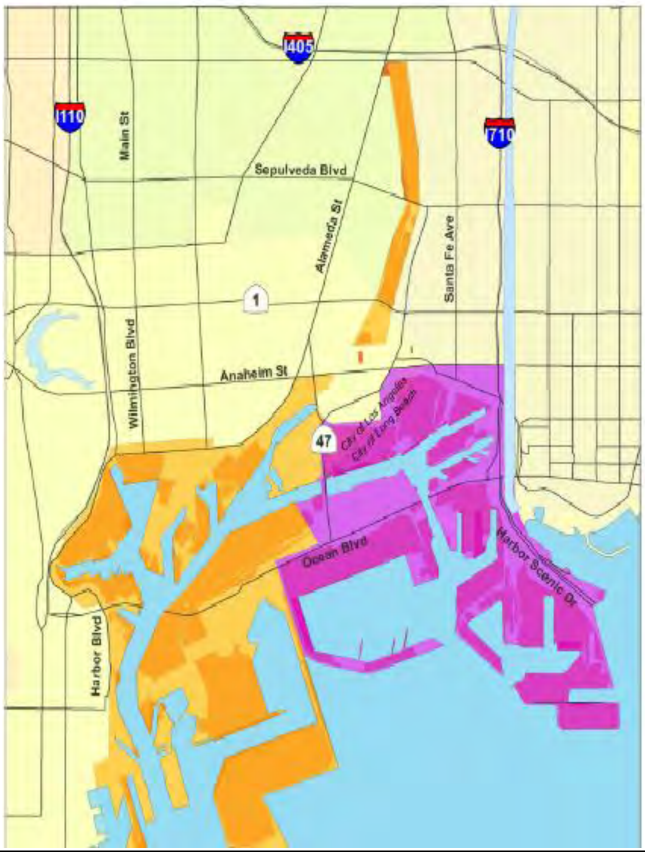
Regional, state, and federal regulators pushed the Port of Los Angeles and the Port of Long Beach to adopt a plan to reduce pollution. In 1998, California declared diesel particulate matter a toxic air contaminant. The California Air Resources Board estimated that diesel particulate matter contributed to 3,500 premature deaths, 250 cases of lung cancer, and thousands of hospital visits that year.[16] The South Coast Air Basin, within which both ports are located, has been designated by the U.S. Environmental Protection Agency as a nonattainment area for National Ambient Air Quality Standards.[17]

Ultimately it was the South Coast Air Quality Management District's aggressive air quality improvement program that imposed a clean-up. The District insisted that if the ports did not clean up their docks and trucks, they would not be able to build or operate new infrastructure.[18] In 2006, the boards of both ports passed the San Pedro Bay Ports Clean Air Action Plan.

Two Separate Clean Trucks Programs

The Clean Air Action Plan called for truck emissions of diesel particulate matter to be reduced 80% below 2005 levels by 2012. The Port of Los Angeles and the Port of Long Beach each adopted a Clean Trucks Program with this goal in mind.

FIGURE 2: TRUCKS HAULING INTERMODAL CONTAINERS ON THE 710 FREEWAY



SOURCES: map from Port of Long Beach 2010 Air Emissions Inventory[19]; photo by Tom Polteio for the Sierra Club

These programs both went into effect on October 1, 2008 and were similar in their efforts to phase out older heavy duty diesel trucks by prohibiting trucks built before a given year from entering the port. However, the Clean Trucks Programs differed in that the Port of Los Angeles program set stricter regulations on who could own and operate trucks servicing its port.[20] (Note that the Port of Los Angeles did not pluralize the word "truck" in its official program.)

Port of Los Angeles Clean Truck Program

The Port of Los Angeles banned all trucks manufactured prior to 1989 from entering the port, effective October 1, 2008. Trucks manufactured prior to 2003 were required to be rehabilitated by January 1, 2010 in order to be granted access. But owners could apply for a waiver to obtain more time if they were in the process of acquiring a new clean truck. The Clean Truck Program mandated that all trucks be in full compliance with 2007 EPA emissions standards by January 1, 2012.[21]

The Clean Truck Program also sought to prohibit independent contractors from moving cargo on behalf of brokers identified as licensed motor carriers. Licensed motor carriers held permits from the U.S. Department of Transportation allowing them to provide services to cargo owners. They, in turn, contracted with independent truck drivers to do the trucking from the ports. The Port of Los Angeles's effort to alter this structure was the most controversial component of the Clean Truck Program.

Under new regulations, licensed motor carriers would operate under five year $2,500 concession agreements with the port, would pay a $100 annual fee per truck in their service, and would be subject to new safety and security regulations.[22] Drivers would have to be employees of the licensed motor carriers, who would be responsible for providing wages, benefits, overtime pay, and payroll taxes. As employees, truck drivers would also be eligible to apply for membership in the Teamsters Union.[23]

Producing new members for the Teamsters Union was a direct motivation for the Port of Los Angeles in writing the concession agreement into the Clean Truck Plan. Port executives stated on the record that the primary motivation for the employee driver provision was the belief that regulating a few hundred licensed motor carriers would be more efficient than regulating over ten thousand independent truck drivers.[24] However, behind the scenes, Los Angeles Mayor Antonio Villaraigosa had instructed port leaders to collaborate with the Teamsters Union.[25] A former union organizer, Villaraigosa met with Teamsters' Union President James Hoffa in 2006.[26] The Teamsters wanted to gain access to new members and the best way to make it legal for truck drivers at the Port of Los Angeles to join the union was to make them employees.

Some independent truck drivers and nearly all licensed motor carriers balked at the new regulations. The most successful, longtime independent contractors who fully owned their own heavy duty diesel trucks and had good contracts with licensed motor carriers felt that their occupation was under attack. They doubted that they would be able to maintain their net income as employees. Licensed motor carriers feared that their profits would be cut if they were forced to purchase expensive new clean trucks and become legal employers of truck drivers rather than brokers between cargo owners and independent truck drivers. The American Trucking Associations launched a lawsuit against the Port of Los Angeles seeking to block the Clean Truck Program concession agreements from going into effect.

Port of Long Beach Clean Trucks Program

Like its partner in the San Pedro Bay Ports Clean Air Action Plan, the Port of Long Beach banned trucks manufactured prior to 1989 from entering the port, effective October 1, 2008. Trucks manufactured prior to 2003, but not earlier than 1994, could be rehabilitated with clean truck technology and access the port. By January 1, 2012 all trucks were required to meet EPA emissions standards set in 2007.[27] These dirty truck phase-out requirements were nearly identical to those set forth by the Port of Los Angeles.

The Port of Long Beach initially desired the revenue and security of a concession system similar to the one invented by the Port of Los Angeles. But it did not wish to engage in a drawn-out legal battle with the American Trucking Associations. It reached an agreement with trucking industry in 2009 that compelled both licensed motor carriers and independent truck owners to register with the port. The one-time registration fee of $250—plus a $100 annual fee for each truck in a licensed motor carrier's service—pays for programs which allow the port to regulate and communicate with the brokers and individuals who operate within its jurisdiction every day. Licensed motor carriers may own clean trucks and hire employees to haul loads. They may pay independent truck drivers who own their own clean trucks to haul loads. Alternatively, they may lease clean trucks to independent contractors and pay them to haul loads.[28]

Lobbying Congress and Fighting Lawsuits

Immediately after the Port of Los Angeles and the Port of Long Beach published the details of their Clean Trucks Programs, the American Trucking Associations announced that it would sue both ports. The Port of Long Beach opted to bargain with the trucking industry and reached a settlement which relaxed many of the provisions in its plan. With the backing of Mayor Villaraigosa, the Port of Los Angeles elected to fight for the right to regulate its port in the way it saw fit. The Port is a department of the City of Los Angeles,[29] which has traditionally been friendly to unions,[30] and it wanted to create an environment where port workers could unionize.

The Port of Los Angeles sought to establish a concession system that would put the responsibility for owning, operating, and maintaining clean trucks in the hands of a few hundred

licensed motor carriers. It demanded that licensed motor carriers hire truck drivers and treat them as employees rather than independent contractors. The American Trucking Associations alleged that the port was overstepping its legal bounds and that the industry should be regulated by Congress.[31] However, the Port of Los Angeles insisted that it had legal authority to regulate activity taking place on its property as a matter of security. Nonetheless, the port realized it might not prevail in a lawsuit if the courts took a narrow view of the federal motor carrier provision in the Federal Aviation Administration Authorization Act of 1994,[32] and thus the port lobbied Congress to amend the law.

Hearing in Washington, D.C.

On May 5, 2011 the House Committee on Transportation and Infrastructure held a hearing regarding a bill introduced by Representative Jerrold Nadler (D-NY), H.R. 572: Clean Ports Act of 2011.[33] Deputy Executive Director of Operations at the Port of Los Angeles John Holmes and Deputy Executive Director at the Port of Long Beach Chris Lytle both testified. The directors were asked about the relative successes of their Clean Trucks Programs and whether there was need for Congress to amend the law to provide the ports greater authority to regulate activities on port property.[34] The committee also reviewed hundreds of pages of written testimony. Most of the testimony from trucking industry groups called for the federal government to continue to serve as the primary regulator of their industry through enforcement of the Federal Aviation Administration Authorization Act.[35]

John Holmes of the Port of Los Angeles testified that every port in the United States was different and each required different regulatory powers in order to be successful in reducing pollution and creating jobs and economic growth. He suggested that the Port of Los Angeles needed the power to regulate who owned and operated trucks on its property. If it didn't, the port would not be able to enforce its own regulations effectively on the age and emissions standards of trucks entering the property. In order to enforce its Clean Truck Program, Holmes argued that the port must be allowed to operate a concession system.[36] Los Angeles Mayor Antonio Villaraigosa supported him[37] and several environmental groups submitted written testimony affirming Holmes' position.[38]

Chris Lytle of the Port of Long Beach agreed with Holmes that a relationship with truck owners and operators was necessary in order to ensure they were in compliance with regulations. However, Lytle felt that this could be accomplished sufficiently through a registration system, which is less restrictive than a concession system. He described the Port of Long Beach's registration system as successful. Lytle also argued that it offered flexibility to truck drivers to operate as independent contractors or to work as employees of licensed motor carriers.[39]

Committee Chairman Peter DeFazio (D-OR) and Ranking Member John Duncan (R-TN) sympathized with Lytle's view. In their questioning of Holmes, the politicians examined whether the concession system was truly necessary to meet pollution reduction goals or whether it was a tool for meeting other objectives. Holmes maintained that the regulations of the concession system as written into the Clean Truck Program were the only surefire way to reduce diesel particulate matter pollution 80% from 2005 levels and preserve that reduction in future years.[40] He argued that without the concession agreement, the port would not be able to hold licensed motor carriers legally responsible for any of the provisions—environmental or otherwise—in the Clean Truck Program. The committee was not persuaded by Holmes' testimony. But as of this writing, it has not held further debate on H.R. 572 or any other Clean Ports legislation since May 2011.[41]

Ruling in the American Trucking Associations Lawsuit

On September 27, 2011, the Ninth Circuit Court of Appeals in San Francisco ruled that the Port of Los Angeles did not possess the authority to "unilaterally insert itself into the contractual relationship between motor carriers and drivers."[42] The court struck down the employee driver provision that banned truck drivers from operating as independent contractors to licensed motor carriers. The court did not agree with the port's assertion that in order to maintain pollution reductions it needed to establish restrictive concession agreements with a small group of truck owners.

The court upheld the Clean Truck Program provisions banning dirty trucks from entering the port. It also upheld the right of the port to use concession agreements, but ruled that the employee driver provision went beyond the port's legal authority.[43] The Port of Los Angeles

drafted a release declaring that "the court affirmed that all provisions of the Port of Los Angeles concession agreement are enforceable except for one, reversing the decision on the employee driver requirement."[44] The Port of Los Angeles maintained that the concession program would go forward, albeit without its most significant provision.

California Senate Bill 459

On October 9, 2011 Governor Jerry Brown signed California Senate Bill 459 into law, strongly increasing penalties against employers who willfully misclassify workers as independent contractors when they should be treated as employees.[45] The law applies to all employers in the California labor economy and will be enforced by the California Labor and Workforce Development Agency and the State Labor Commission. Employers found to be in violation will be fined $5,000 to $15,000 per occurrence or up to $25,000 per occurrence if they are found to have engaged in a pattern of violations.[46]

Labor groups representing truck drivers have seized on the new legislation, demanding that California regulate perceived abuses by the trucking industry. Advocacy group Los Angeles: A New Economy (LAANE) argues that licensed motor carriers throughout the Port of Los Angeles and the Port of Long Beach are in violation of the law. They are joined by the Coalition for Clean Safe Ports, which points to workers like Leonardo Mejia:

> "He works for a company called Shippers Transport Express, a subsidiary of the massive SSA Marine, which is itself half-owned by Goldman Sachs. Shippers Transport classifies Mejia as an independent contractor, and gives him an IRS Form 1099 instead of a W-2. But Mejia shows up for work every day at the time and place that the company tells him to. He accepts every truck load given to him by the company, or risks loss of future work assignments. He drives a truck that is registered to the company, and his lease with the company specifies that he cannot use the truck to drive for any other company. He does not bargain for the rates he is paid: the rates are set by the company, and he can take it or leave it. If he chooses to leave it, he turns in his truck and looks for another job."[47]

There are thousands of workers like Mejia, not just at the Ports of Los Angeles and Long Beach, but nationwide. Whether California SB 459 will eventually move them into employee status is not yet known. (See FIGURE 3).

FIGURE 3: U.S. Port Truck Drivers Status

Drivers classified as	
Employees	17.8%
Independent Contractors	82.2%
Direct Contractors	69.8%
Sub-haulers[28]	12.4%
Annual income, net of truck expenses	
Median	
Contractors	$28,783
Employees	$35,000
Mean	
Contractors	$33,081
Employees	$38,000
Hours per week (all drivers)	
Median	59.0
Mean	55.7
Hours per day (all drivers)	
Mean	11.7
Wages per hour (means)	
Contractors	$11.91
Employees	$14.71
Have health insurance	
Contractors	25.1%
Employees	65.0%
Have retirement plan	
Contractors	7.3%
Employees	20.8%

SOURCE: meta-analysis by Smith, Bensman, and Marvy[48]

Clean Ports Act of 2011

On December 16, 2011, Senator Kirsten Gillibrand (D-NY) introduced the Clean Trucks Act of 2011 in the Senate. It complements Representative Jerrold Nadler's bill in the House and was co-sponsored by fellow New York Senator Charles Schumer, Al Franken (D-MN), Robert Menendez (D-NJ), and Barbara Boxer (D-CA).[49] The bill would allow the Port of New York/New Jersey to exercise many of the same powers that the Port of Los Angeles wrote into its concession agreements, and might allow the Port of Los Angeles the opportunity to re-introduce the employee driver provision.[50] The bill has major support from Democrats, labor

groups, and environmental groups, while the American Trucking Associations opposes it. Whether such a bill could be enacted will depend on the future composition of Congress.

Costs and Benefits of Clean Trucks Programs

Strong financial investments in grant programs for clean trucks at the two ports prompted an enormous reduction in pollution. The Clean Trucks Programs produced a steep decline in diesel particulate matter and oxides of nitrogen observed near the ports. But there is no free lunch and some actors were harmed by the programs. Some independent truck drivers and licensed motor carriers with old trucks did not upgrade their trucks and were forced to exit the business of short distance trucking to and from the ports.

Funding Costs

The Port of Los Angeles, the Port of Long Beach, and South Coast Air Quality Management District all got into the business of encouraging the conversion to clean trucks through grants to independent truck drivers and licensed motor carriers. The Port of Los Angeles awarded 2,200 grants of $20,000 each (a total of $44 million) to licensed motor carriers who purchased and operated at least one new clean truck by January 15, 2009.[51] By 2010, the Port of Long Beach had awarded at least 250 grants, totaling $32.8 million.[52]

When the budget for the two programs was exhausted, the South Coast Air Quality Management District provided additional funding to both ports, facilitating the conversion of an additional 1,500 trucks to clean diesel or liquefied natural gas. Of the three agencies, the Port of Long Beach awarded the largest grants, averaging $131,000 each, but its grant money evaporated quickly as independent truck drivers and licensed motor carriers rushed to take advantage. In total, the three agencies spent more than $100 million to provide grants for clean trucks.

Most of the money used to fund the clean truck grant programs at the Port of Los Angeles and the Port of Long Beach was raised through a $35 tax on each twenty foot equivalent unit (TEU) multimodal container unloaded from a ship onto a truck. Initially, both ports proposed raising money to fund their clean trucks grant programs by heavily taxing each load carried by older, polluting heavy duty diesel trucks. This tax would have applied during the four years that such trucks were being phased out, but that plan was struck down by multiple courts.[53] The

result has been that multi-national shipping companies have indirectly contributed millions of dollars to upgrade the truck fleets at the Port of Los Angeles and Port of Long Beach.

Nevertheless, independent truck drivers and licensed motor carriers contributed the largest share of the money to update to clean trucks. While the ports provided more than $100 million in grants, private investment in truck rehabilitation and new clean truck purchases exceeded $1 billion.[54] The Port of Los Angeles grants covered about 20% of the average cost for 2,200 new clean trucks, meaning the program spurred the purchase of 2,200 new clean trucks with 80% investment from private owners and operators. The Port of Long Beach covered almost 80% of the costs of new trucks—especially liquefied natural gas trucks—spurring private investment of tens of millions of dollars. Additionally, thousands of truck drivers and licensed motor carriers were unable to secure grants for clean trucks but used their own capital or borrowed money to upgrade their trucks.

Clean Air Benefits

The benefits of the Clean Trucks Programs were swift and substantial. On January 1, 2012, trucks were required to meet the 2007 EPA emissions standards in order to enter the Port of Los Angeles and the Port of Long Beach. By that time, the two ports had exceeded the 80% diesel particulate matter pollution reduction target set forth in the San Pedro Bay Ports Clean Air Action Plan.[55] In fact, the ports nearly met this goal in the first two years of the Clean Trucks Programs operation when heavy duty diesel trucks manufactured before 1993 were banned.[56] In the first two years, the Port of Long Beach reduced overall diesel particulate emissions at its port by 72% from 2005 levels, oxides of nitrogen 42%, and greenhouse gasses 18%.[57]

Today, every truck servicing both ports is clean and emissions are still being reduced. At the Port of Los Angeles, 9,800 clean trucks move 100% of the containers being trucked short distances away from the port to rail yards and distribution centers.[58] Every truck meets the EPA's standards for clean trucks. At the Port of Long Beach, 11,000 clean trucks haul 100% of the short distance loads.[59] In aggregate, the Clean Trucks Programs at the two ports have reduced annual diesel particulate matter emissions by more than 40 tons.

The great reductions in diesel particulate matter and oxides of nitrogen will have enormous health benefits locally. The California Air Resources Board estimated that before the

Clean Trucks Programs were enacted, Southern Californians spent \$100-\$590 million annually on health care related to pollution from dirty trucks serving the ports.[60] An 80% reduction in pollution—particularly localized pollution near the 710 and 110 freeways—will save citizens billions of dollars in future health costs and reduce pain and suffering.

Industry Effects

Today, licensed motor carriers complain that there are not enough independent truck owners available to service their customers as independent contractors. The *LA Business Journal* reported that one trucking executive reported his firm, which utilized about 200 independent owner-operators, was short 20-30 drivers and that he would have to raise pay to fill the vacancies.[61] Licensed motor carriers argue that the ports' regulations combined with the high cost of new clean trucks have driven thousands of drivers away from the industry. They demand that the ports set up programs to train more drivers and provide more financing for new clean trucks.

There are many fewer trucks servicing the ports than there were before the Clean Trucks Programs were implemented. Where there were once 18,000 trucks, mostly owned and operated by independent drivers, there are now 11,000 trucks.[62] The majority of truck drivers at the ports still work as independent contractors for licensed motor carriers. There are fewer total drivers mostly because of the high cost of purchasing new clean trucks, but also because the economic recession of 2007 drove some drivers into retirement. Additionally, truck drivers tend to be older as a demographic, and more of them are reaching retirement age than are coming into the workforce.[63]

The industry is not likely to go into crisis because of a lack of trucks or truck drivers. While the high fixed cost of new clean trucks has limited the number of trucks, it has also necessitated more efficient uses of each truck. Independent truck drivers may find it economical to share their trucks between two owner-operators and licensed motor carriers may find that they can provide one truck for multiple employees to share. The high cost and somewhat limited supply of clean trucks also provides a disincentive to idling trucks for hours at a time at the ports or in neighborhoods nearby.[64] In 2010, trucks idled for nearly two million hours on Port of Long Beach property alone.[65] There is a high unemployment rate in Southern California at this writing

in the aftermath of the Great Recession. Thus, it can be expected many people will be available to drive trucks if the right incentives and training programs are established by the public and private sectors.

The licensed motor carriers and the trucking industry in Southern California may decide it is in their interest to hire more employee truck drivers if the shortage of truck drivers persists and the recent growth in container imports continues. As the United States has recovered from the Great Recession, the combined containers offloaded at the Port of Los Angeles and the Port of Long Beach has risen each of the last two years.[66] As noted earlier, California has passed Senate Bill 459, promising to punish employers who willfully misclassify workers.

The Teamsters Union continues to encourage port truck drivers to demand full employment and the right to join the union. Licensed motor carriers voluntarily hiring more employee truck drivers would please the port operators, which have been pressuring the industry to hire workers since the Clean Trucks Programs were announced. This convergence of pressure may force the industry to adjust.

Lessons

1) It is possible to establish a Clean Trucks Program and dramatically reduce air pollution within a few years. The Port of Los Angeles and the Port of Long Beach established the San Pedro Bay Ports Clean Air Action Plan in 2006 and by the first day of 2012, cancer-causing, toxic diesel particulate matter pollution was reduced by more than 80%. Most of the benefits of the program came within the first two years.

2) Grants for new technology will spur private investment. One hundred million dollars of funding for clean trucks grant programs generated over $1 billion in private investment in clean trucks. Of course, private money would have been invested with or without grants in order to meet emissions mandates set forth in the Clean Trucks Programs. It is difficult to estimate what portion of private investment was influenced by private grants and what portion would have been spent regardless. One conclusion is that grants need not cover a large percentage of the purchase price of a new vehicle, as average grants at the Port of Los Angeles were less than 1/6 as large as those of the Port of Long Beach, yet both ports exhausted their funds and had to deny grant applications.

3) <u>The trucking industry will resist changes it perceives as financially threatening.</u> This lesson speaks to the nature of any large industry when confronted by government. Rarely do industries willingly agree to new regulations, especially when they introduce new costs and taxes. The American Trucking Associations has fought the Port of Los Angeles and the Port of Long Beach relentlessly over each new regulation and fee. The trucking industry managed to compel the Port of Long Beach to institute a registration system instead of a concession system, and to halt the concession system imposed by the Port of Los Angeles. At both ports, the trucking industry has maintained its independent contractor model. Under that model, it does not have to provide overtime pay or benefits to drivers and does not pay payroll taxes to the State of California.

4) <u>Government agencies' best strategy is to set strict regulations and bargain down.</u> The most important environmental components of the Clean Trucks Plans from ports' point of view survived the bargaining table and the lawsuits. The ports were able to begin the ban on pre-1993 heavy duty diesel trucks on time. The scheduled phase-out of old, polluting trucks was never interrupted. They were also able to collect a $35 fee for each TEU intermodal container offloaded from a ship to a truck throughout the duration of the phase-out. The ports did not achieve the lucrative revenue stream from polluting trucks they initially sought and the concession agreements have not been installed as originally planned. Nonetheless, the ports managed to implement and fund programs which have reduced pollution dramatically.

5) <u>Truck drivers are no better off.</u> There are 7,000 fewer trucks servicing the ports in 2012 than there were in 2006. The trucks in service today are cleaner, but they are also much more expensive. Most drivers are still independent contractors and do not enjoy benefits or overtime pay. Independent drivers earn slightly higher commissions per load they haul, but they are burdened by costlier mortgages and leases.

Framework for Successful Clean Trucks Programs at Other Ports

The following are five steps that other ports in the United States (the Port of New York/New Jersey, for instance) can take to create a Clean Trucks Program that achieves goals at a reasonable cost without excessively harming private individuals or businesses.

1) Construct precise standards for clean trucks and a precise timeline for replacing heavy duty diesel trucks with refurbished trucks or new clean trucks. Ports should establish the amount of pollution they want to curtail and calculate how many trucks need to be converted from polluting at their current levels to polluting at specific levels allowed by the 2007 EPA standards. Then they should set specific dates for banning dirty trucks from operating on their property, just as the Port of Los Angeles and the Port of Long Beach did.

2) Establish a grant program that encourages as many clean truck conversions as possible. Ports should focus on awarding a large quantity of grants to whoever is willing to remove a dirty truck from operation and purchase a new clean truck. Whether these people are independent truck drivers or licensed motor carriers should not be primary criteria for granting awards. If enough new trucks are purchased, they will be put to use and drivers will be employed to haul loads.

3) Set the grant awards at as low a price as possible to facilitate private investment. If thousands of independent truck drivers and licensed motor carriers are willing to purchase new clean trucks upon being awarded a $10,000 or $20,000 grant, there is no sense in awarding $100,000 grants. Awarding many moderate sized grants will facilitate more clean truck purchases than awarding few large grants. Furthermore, it will allow the grant program to extend for months or years, rather than running out of money quickly and angering people who missed out on the opportunity.

4) Only regulate what needs regulating. The goal of a Clean Trucks Program should not be to restructure an entire industry. In California, there are laws to punish employers who misclassify or mistreat their workers. The Port of Los Angeles is not the agency in charge of enforcing those laws, nor should it be. By keeping their aims narrow, ports can concentrate on the most important components of their programs. Furthermore, by avoiding tangential conflicts with the trucking industry, ports will have more leverage when it comes to defending their primary objectives.

5) Innovate new ways to help independent truck drivers. Instead of trying to help truck drivers indirectly by mandating that the trucking industry employ them, ports should devise new strategies to save independent truck drivers money and provide them services. Ports could reduce entry and exit tolls which are primarily paid by truck drivers, establish a program for workman's compensation insurance and health insurance, and provide facilities such as break rooms, restrooms, and lockers for independent drivers.

Conclusion

The Clean Trucks Programs at the Port of Los Angeles and the Port of Long Beach were extraordinarily successful in quickly reducing pollution. The programs have not harmed the economy significantly, although the trucking industry fought regulation of their industry and prevented the employee driver provision from being enforced. As the principal arrival point for international trade in the United States, the San Pedro Bay ports will continue to process millions of intermodal containers each year, and trucks will haul most of these containers at least a short distance.

The experience of the Port of Los Angeles and the Port of Long Beach in establishing Clean Trucks Programs offers several lessons. It is possible to establish pollution reduction targets and meet them on time. Grant programs will spur private investment in cleaner technology. The trucking industry will fight regulation and government's best response may be to initially set strict regulations and bargain down if necessary. Residents living near ports and heavily traveled roadways will benefit from Clean Trucks Programs, but truck drivers may or may not experience improvements in their lives.

Other ports in the United States can learn from the Port of Los Angeles and the Port of Long Beach. In establishing successful programs, they should construct precise standards and timelines for replacing dirty trucks. They should award many small grants to all parties willing to invest private capital, with the goal of creating as many conversions as possible. Finally, ports should refrain from attempting to regulate every aspect of the trucking industry and focus on directly improving conditions for independent truck drivers.

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CHAPTER 6

Getting Better: An Update on Security at the Ports of Los Angeles and Long Beach

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William Sholan was a student in Public Policy 10B in Winter 2012.
This chapter is adapted from a report written for that course.

The Los Angeles/Long Beach Port complex is a vital component of the United States economy and a regional asset to the State of California and the cities of Los Angeles and Long Beach. In the United States, approximately 95% of overseas commerce by volume travels through U.S. seaports.[1] Yet when port security was last reviewed in *California Policy Options* in 2005, there were significant gaps in port security despite the fact that the twin ports handled over 40 percent of all shipping containers entering or leaving the U.S.[2]

Due to the economic importance of the port complex, it is widely viewed as a major target for terrorism. Apparent vulnerabilities make maritime ports an attractive option for terrorist acts. The 9/11 commission and other bodies have identified the potential for great harm through maritime terrorism.[3]

This chapter finds that the implementation of provisions prescribed in the 2006 Security and Accountability for Every (SAFE) Port Act has addressed at least some of the key vulnerabilities that were earlier identified. Notably the expansion of Interagency Operational Centers (IOCs) and the creation of the Port Security Grant Program (PTSP) have effectively worked toward addressing the threat of terrorism at the port complex. Interagency Operational Centers have improved coordination, communication, and cohesion between agencies. At the same time, the port security grant program provides the port complex with the financial support to upgrade both security personnel and facilities.

I. The Zegart-Hipp-Jacobson Study

In a 2005 chapter in *California Policy Options* on port security at the LA-Long Beach Complex, UCLA Professor Amy Zegart and two student co-authors, Matthew Hipp and Seth Jacobson, identified major problems at the port complex that made it susceptible to a terrorist attack. One problem was a lack of coordination and oversight among the agencies involved in

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[1] *The Safe-Port Act: A 6th Month Review: Hearing Before the Subcommittee on Border, Maritime, and Global Counterterrorism of the Committee on Homeland Security House of Representatives*, (Washington: GPO, 2007), p. 2. Available at http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg48906/pdf/CHRG-110hhrg48906.pdf.

[2] Amy Zegart, Matthew Hipp, and Seth K. Jacobson, "Port Security: Improving Emergency Response Capabilities At the Ports of Los Angeles and Long Beach" in Daniel J.B. Mitchell, ed. *California Policy Options: 2005* (Los Angeles: UCLA School of Public Affairs, 2005), pp. 181-197. Available at http://www.spa.ucla.edu/calpolicy/files05/zegartcpotextorigedit.pdf. The 2005 chapter was in turn a review of an earlier 2003 consulting study by Zegart and others reviewing port security problems.

[3] U.S. Coast Guard, "Interagency Operations Centers." Last modified January 26, 2012. Accessed February 13, 2012. Available at http://www.uscg.mil/acquisition/ioc/.

providing security.[4] Zegart-Hipp-Jacobson noted that poor coordination among agencies and the absence of a formal leader diminished their effectiveness in response to a terrorist attack.[5] In addition, they found that limited accessibility to the port complex in the aftermath of an incident could be disastrous in slowing a response to such an attack.

Since traditional first responder staffing levels at the complex would be low, access into the port becomes critical. However, only two key roadways have access into the port area.[6] Zegart-Hipp-Jacobson argued that this problem greatly increases port vulnerability to terrorism. Lastly, Zegart-Hipp-Jacobson underscored that the communications systems used were not compatible among agencies.[7] Very few radios were compatible with those used by other agencies so many first responders would be unable to communicate, greatly reducing emergency response effectiveness.[8]

II. The Type of Terror Threat

There are myriad scenarios for potential terror attacks on the maritime transportation system. Government leaders and security exports are worried that terrorists could smuggle personnel, weapons of mass destruction, or other dangerous materials into the U.S.[9] An attack at the LA-Long Beach Port complex is a major possibility. One scenario involves a type of attack on a ship in port; another consists of "dirty" bombs in containers at multiple U.S. ports.[10] Similarly, an attack could involve the coordinated bombing of docks and bridges, and the mining of the harbor at a major commercial port.[11]

III. The Economic Worth of the LA-Long Beach Port Complex

The LA-Long Beach Port Complex contributes importantly to the local, state, and national economy. The Los Angeles Port alone is connected directly and indirectly with billions

[4] Zegart-Hipp-Jacobson, p. 183
[5] Ibid.
[6] Ibid, p. 190.
[7] Ibid, p. 194.
[8] Ibid.
[9] Jonathon Vesky, *Port and Maritime Security* (New York: Nova Science, 2008), p. 13.
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[11] Ibid.

of dollars in industry sales each year.[12] As a result, the LA Port is essential to the survival of port-linked industries involved in freight logistics and cruise passengers. Beyond those sectors are port users, the businesses that depend on the port to receive imports or ship exports.[13] Moreover, the LA Port supports port customers who are retail or other non-cargo businesses in the port.[14] The Port of Long Beach is roughly the same size as the Port of LA and so the economic impact of the complex is roughly double that of either individual port.[15]

Any substantial terror attack at one or both of these ports could have a devastating effect on the local, state, and national economy. A labor dispute – a lockout of workers by port employers – and subsequent 10-day closure of western ports in 2002 was used by Zegart-Hipp-Jacobson to simulate the impact of a port disruption.[16] The shutdown in its first five days cost the U.S. economy $4.7 billon.[17] As Zegart-Hipp-Jacobson note, the impact of a closure due to terrorism could be much larger because of the surprise nature of an attack (so users could not plan ahead) and the likelihood of a lengthy closure.

IV. Agency Responsibility for Maritime Security

The Coast Guard, which is under the jurisdiction of the federal Department of Homeland Security, plays a major role in securing the LA-Long Beach port complex. Congressional enactment of the Maritime Transportation Security Act (MTSA) of 2002 sought to help protect the nation's ports and waterways from terrorist attacks by requiring a range of security improvements. Under the Act, the U.S. Coast Guard became the lead agency for coordinating all maritime security planning operations for U.S. ports.[18]

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[12] The Port of Los Angeles, "Economic Impact." Accessed February 13, 2012. Available at http://www.portoflosangeles.org/finance/economic_impact.asp.
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The Coast Guard evaluates, boards, and inspects commercial ships as they approach U.S. waters.[19] Moreover, the MTSA authorized the Coast Guard to create area committees composed of federal, state, local, and industry members to develop the local plans for the ports.[20] Each committee has the flexibility to assemble and operate in a way that reflects the needs of its port area.[21] The Coast Guard and the Transportation Security Administration (TSA) are jointly responsible for overseeing the Transportation Worker Identification Credential (TWIC) program to regulate and screen employees who service the ports.[22]

In coordination with the Coast Guard, the U.S. Customs and Border Protection (CBP) has a vital role in port protection. The CBP is responsible for inspecting containers and ship crews as well as cruise ship passengers arriving in U.S. ports.[23] Similarly, CBP pre-screens U.S.-bound containers at selected foreign ports.[24]

The Federal Bureau of Investigation (FBI) helps coordinate law enforcement efforts in collaboration with other agencies including the Coast Guard and several police forces as part of a local joint terrorism task force (JTTF).[25] At the local level, the FBI sits on Area Maritime Security Committee meetings along with police and fire departments, port executives, and other agency representatives.[26] The FBI and the Coast Guard serve as co-coordinators of the Area Maritime Security Committee.[27]

According to Arthur Goodwin, Director of Planning for the Alameda Corridor (the rail link to the LA/Long Beach ports), the Corridor contracts with the Union Pacific and BNSF railway police departments to provide security for the rail connection to the ports. All cargo that moves on the Alameda Corridor is classified as "common carriage" under federal law. Thus, the

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[19]Thomas O'Brien, "Port Security: Guarding America's Front Door" (University of Southern California/California State University-Long Beach, METRANS Transportation Center, 2007), p. 2. Available at http://www.metrans.org/documents/WhitePaper2-6-07.pdf.
[20] *The Safe-Port Act: A 6th Month Review*, ibid.
[21] Ibid.
[22] Ibid. p. 3.
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] Ibid. p. 8.
[27] Ibid.

railroads are "100% responsible" for the trains, crews, and cargoes being carried.[28] Railroad police provide random port security patrol services as necessary.[29]

V. Port Complex Areas of Vulnerability

In their 2005 chapter, Zegart-Hipp-Jacobson highlighted disturbing deficiencies in agency coordination and oversight. The fragmented and anarchic agency structure was seemingly unprepared to efficiently respond to a terrorist attack at the port complex. Although the Coast Guard was the *de facto* leader according to stipulations in the MTSA, other agencies were still not sure of its role.

It was unclear whether the Secretary of Homeland Security was in charge of domestic incident management or whether responsibility fell on state or local authorities.[30] Similarly, state law indicated that agencies should abide by the "Incident Command System," which indicated that agency control depends on the nature of the event.[31] During a multi-jurisdictional event, agencies are supposed to establish a "Unified Command" whereby decision-making responsibility is dispersed within a group of agency managers.[32] In essence, there was no formal leader in the event of an emergency situation at the port complex.[33]

Divided Political Control

Another problem affecting quality of coordination at the time of the Zegart-Hipp-Jacobson chapter was the reality that the Port of Los Angeles and Long Beach are governed by two different political entities.[34] As a result, the two ports inherently function with different management structures, different police departments, and separate fire departments.[35] Due to the two-jurisdiction nature of the port complex, Zegart-Hipp-Jacobson worried that the various

[28] Arthur Goodwin, Director of Planning for the Alameda Corridor, interview by the author, May 14, 2012.
[29] Ibid.
[30] Zegart-Hipp-Jacobson, p. 183
[31] Ibid
[32] Ibid
[33] Ibid
[34] Ibid.
[35] Ibid.

agencies involved would respond to a terrorist attack in a dysfunctional and uncoordinated manner.[36]

Inaccessible Location

Still another inherent port complex vulnerability at the time of the Zegart-Hipp-Jacobson chapter was its inaccessible location. Port location is troublesome because among the LA Port Police, the Port of Long Beach Harbor Patrol, and the LA and Long Beach Fire Department, there are only 100 sworn law enforcement officers and firefighters assigned to the port complex during a typical shift.[37] With first responder staffing at a minimally low level, outside assistance in the case of a crisis is essential.[38] The 110-Harbor Freeway and 710-Long Beach Freeway, however, are the only major roadways that have access into the port complex.[39] Unfortunately, these roadways are often congested with traffic from an estimated 35,000 cargo trucks that travel to and from the port complex each day along with non-port linked vehicles.[40] As a result, first responders traveling from their headquarters in downtown LA and elsewhere would take between one and one-and-a-half hours to arrive on scene.[41]

Need for Training Expansion

To address the shortage of first responders, Zegart-Hipp-Jacobson recommended Community Emergency Response Training (CERT) be provided to port workers and civilians. The recommended program was intended to train civilians on how to provide assistance during disaster situations.[42] Such training would, according to Zegart-Hipp-Jacobson, greatly enhance port emergency response capabilities.

Need for Improved Communication

The lack of compatible communication systems among agencies found by Zegart-Hipp-Jacobson exacerbated the agency coordination problem. Prior to the 9-11 terrorist attacks in New York and Washington, DC, only a select few radios were compatible with those used by other

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[36] Ibid.
[37] Ibid, p. 190.
[38] Ibid.
[39] Ibid.
[40] Ibid.
[41] Ibid.
[42] Ibid, 191.

agencies. As a result, in the event of an emergency, responding agencies were only able to communicate within their own workforce and not *between* agencies.

To alleviate this problem, the Port of Los Angeles initially decided to purchase a mobile First Responder for use at the complex.[43] This mobile plan-and-control system had the technology needed to allow for interoperability between radio stations and different frequencies.[44] It was one possible solution to the lack of interagency communication. However, despite the recognized need for a solution to the communication barriers, at the time of the Zegart-Hipp-Jacobson chapter, the Port Police had not yet required this system.[45] At the time, the port complex still relied on outside agencies such as the LA Sheriff's Department to provide equipment for interagency communications.[46] But as noted earlier, this approach was dangerous considering that there would likely be delays in getting the equipment to the complex following a terrorist attack due to the inaccessibility problem.[47]

VI. LA/Long Beach Port Complex Security Improvements

With the mandates required by the SAFE Port Act of 2006, many of the vulnerabilities underscored by Zegart-Hipp-Jacobson have been addressed, at least partially. The SAFE Port Act, which authorized $3.4 billion over five years to implement security programs, sought to strengthen and expand security programs previously launched and put in place by MTSA.[48] Two key provisions of the SAFE Act that address the concerns of Zegart-Hipp-Jacobson were the Command 21 Project, which expanded Interagency Operational centers, and the Port Security Grant Program.

Interagency Operational Centers

As required by Section 108 of the SAFE Port Act, the Command 21 Project provided the capabilities necessary to create Interagency Operation Centers (IOCs).[49] With only three IOCs in existence in 2006, the Act directed the Department of Homeland Security to establish such

[43] Ibid, 194.
[44] Ibid, 195.
[45] Ibid, p. 195.
[46] Ibid.
[47] Ibid, p. 196.
[48] Thomas O'Brien, p. 5.
[49] *The Safe-Port Act: A 6th Month Review*, ibid.

centers at *all* high-risk priority ports no later than three years after the act's enactment.[50] These IOCs facilitate better collaboration and coordination in emergency preparation and response between the Coast Guard and other national, state, and local agencies. They enable the Coast Guard to share targeting, intelligence, and scheduling information to improve situational awareness with other agencies.[51] Furthermore, these IOCs can help the Coast Guard identify gaps in planned and ongoing operations as well as reduce the duplication of effort between agencies.[52]

In February 2009, the Port of Long Beach opened a $22 million joint command and control center to serve as the central security division for various agencies at all levels of government.[53] The joint command center serves as the official headquarters of the Port of Long Beach Security Division and Harbor Control.[54] It is the center for coordination of agencies such as the U.S. Coast Guard, the U.S. Customs and Border Protection, the Marine Exchange of Southern California, the Long Beach Police Department, and the Port of Los Angeles.[55]

Coordination Now Improved

The establishment of the joint command center at the Port of Long Beach greatly improved the agency cohesion and coordination issue that Zegart-Hipp-Jacobson pinpointed in their 2005 study. Federal and state laws fail to designate a clear leader for port security in an emergency response situation. However, the physical accommodation of numerous agencies in one location allows for more effective responsibility sharing. Similarly, the joint command center significantly enhances intelligence sharing, joint planning, and effective resource allocation. By bringing the port's stakeholders together physically and technologically under one roof, there is reported to be more trust among the agencies.[56]

[50] Ibid.
[51] U.S. Coast Guard, "Interagency Operations Centers." Last modified 1/26/2012. Accessed February 13, 2012. http://www.uscg.mil/acquisition/ioc/.
[52] Ibid.
[53] Art Marroquin, "Port Keeps Security in Focus," *Daily Breeze*, September 4, 2011 (accessed February 13, 2012). Now available only for a fee via archival search at the newspaper website.
[54] Port of Long Beach, "New Facility Enhances Security in Harbor Area." Last modified 9/11/2009. Accessed February 13, 2012. Available at http://www.polb.com/news/displaynews.asp?NewsID=601.
[55] Ibid.
[56] Mike McMullen, "High Tech Security at Port of Long Beach," *Activu Corporation*, 2009. Accessed February 13, 2012. Available at http://www.activu.com/documents/article_high_tech_security_at_port_of_long_beach.pdf.

Furthermore, the Port of Long Beach Interagency Command Center's accommodation of multiple local, state, and federal agencies vastly improves communication between agencies. These IOCs eliminate the port complex's need for mobile interoperable communication systems such as the "First Responder" system that had earlier been recommended. Incompatible interagency communication systems are less of a problem with the new joint command center. The Port Police of Long Beach in its review of purchasing a interoperable communication system opted to pursue a mobile system due to concerns that fixed sites – such as a communication center – would be vulnerable as a target.[57] In response to this concern, the Long Beach Joint Command Center has a direct wireless link to the City of Long Beach's Emergency Command Operations Center to improve the coordinated response during a catastrophe.[58]

New Fund Source

The federal Port Security Grant Program (PSGP) has also dramatically improved security at the LA/Long Beach port complex. The program is intended to enhance maritime domain awareness and risk management capabilities.[59] In 2009, the Ports of Long Beach and LA received $15.3 million in grants to strengthen the security around the complex.[60]

As two entirely self-supporting entities, the Ports of Los Angeles and Long Beach rely heavily on federal grants for port security. With this grant money, the port complex has substantially upgraded facilities, improved technology, and bolstered its security force. Along with the Long Beach Joint Command Center, the Los Angeles Port Police moved into an entirely new $60 million facility in 2011.[61]

Furthermore, security staffing has increased substantially for both ports. The Port of Los Angeles police force has doubled to nearly 150 officers.[62] Similarly, Long Beach authorities

[57] Zegart-Hipp-Jacobson, p. 197.
[58] Port of Long Beach, "New Facility Enhances Security in Harbor Area." Last modified 9/11/2009. Accessed February 13, 2012. Available at http://www.polb.com/news/displaynews.asp?NewsID=601.
[59] Police Grants Help, "Port Security Grant Program." Accessed February 13, 2012. Available at http://www.policegrantshelp.com/grants/1977014-Port-Security-Grant-Program-PSGP.
[60] Homeland Security News Wire." Last modified 10/1/2009. Accessed February 13, 2012. Available at http://www.homelandsecuritynewswire.com/ports-los-angeles-long-beach-receive-153-million-security-grants.
[61] Art Marroquin, "Building will end tight squeeze for force of 150," *Daily Breeze*, July 23, 2011. (Accessed February 13, 2012). Now available only for a fee via archive search at newspaper website.
[62] Art Marroquin., "Port Keeps Security in Focus," Ibid. (Accessed February 13, 2012).

have also doubled their staff over the last decade.[63] The Port of Long Beach has 45 trained and armed public officers who patrol the port complex 24/7.[64] Moreover, these officers are trained to handle emergency response.

The new Maritime Law Enforcement Training Center (MLETC) introduced in April 2011 will teach the country's first maritime curriculum. There will be a training staff comprised of the Los Angeles Port Police, the Los Angeles County Sheriff, and the Long Beach Police Department.[65] There will be comprehensive training on maritime boardings, arrest procedures, vessel-identification, and counter-terrorism practices and procedures.[66]

New Staff

The increase in port staffing levels addressed another vulnerability highlighted earlier. Due to the LA/Long Beach's hard-to-get-to location, outside emergency personnel, according to Zegart-Hipp-Jacobson, would experience difficulty in access into the complex during an emergency situation. To compensate for this anticipated problem, they recommended CERT training for all those who work at the port complex. However, low security staffing levels were one of the main reasons civilian training was recommended in the first place.[67] Trained workers would compensate in part for limited on-site emergency personnel. As a result of increased staffing, the need for CERT training among workers at the port is not as crucial as it was at the time of the 2005 chapter.

VII. Conclusion

The establishment of Interagency Operation Centers and the creation of the Port Security Grant Program provisioned through the SAFE Port ACT of 2006 have greatly improved the emergency response capability of the agencies involved with securing the LA/Long Beach Port Complex. The capabilities of Interagency Operation Centers have transcended many of the

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[63] Ibid.
[64] Port of Long Beach, "New Facility Enhances Security in Harbor Area." Last modified September 11, 2009. Accessed February 13, 2012. Available at http://www.polb.com/news/displaynews.asp?NewsID=601.
[65] Port of Los Angeles, "Port of Los Angeles Opens New Maritime Law Enforcement Training Center," News release, April 28, 2011. Available at http://www.portoflosangeles.org/newsroom/2011_releases/news_042511_Secy_Napolitano_MLETC.pdf.
[66] Ibid.
[67] Zegart-Hipp-Jacobson, p. 193.

vulnerabilities enumerated by Zegart-Hipp-Jacobson in 2005. With various agencies all under one umbrella, this new agency coordination, collaboration, and communication removes the need for compatible communication systems entirely and lessens the need for a formal leader in emergency response.

Furthermore, the Port Security Grant Program has provided adequate financial support for improved security protection and awareness. Without taxpayer money, federal grants such as the PSGP are essential for upgraded facilities and increased staffing and security. Security at the port complex can never be complete but it has improved significantly since 2005.

CHAPTER 7

California's Economic Outlook: Fundamentals Improving but a Long Way to go Before Full Recovery

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This chapter is based on information available in late October 2012.

At this writing, we expect the U.S. economy to grow somewhere in the 2.5% range in the second half of 2013. However, we point out that Beacon Economics' outlook is more optimistic than that of many forecasting organizations. The soft patch in the U.S. economy in mid-2012 seems to us less dire than many other forecasters seem to believe.

There are some dark spots. Economic weakness in the euro zone is not helping the U.S. economy. Problems in Europe have caused the value of the U.S. dollar to rise, and the weak demand for imports from Europe is having a negative effect on the global economy. But the risks from Europe seem overstated. Although European leaders have shied away from taking dramatic policy steps, they have shown resolve in the face of immediate challenges.

On January 1, 2013, the United States will see a sharp increase in taxes and a large decline in federal spending if the two political parties in Congress and the President cannot agree on a budget compromise. The overall shock to the system would amount to roughly $550 billion, or $410 billion in tax increases and $140 billion in spending cuts over the course of 2013. The shock to the country would be substantial, but only if this budget remains in place for a sustained period of time in 2013. In other words, the threat is more of a fiscal hill, where we start down slowly but pick up speed over time. Uncertainty about that issue may have had a retarding effect on growth in 2012. Our view is that it is likely that Congress and the President will find some way to avert a full-blown crisis. Readers of this chapter, of course, will know how that conflict is or is not resolved.

Why does the economy feel so fragile? It has much to do with the fact that we didn't get the same bounce in growth we typically get after recessions. After the mid-1970s and the early-1980s downturns, the economy grew close to 6% for two years erasing economic losses that occurred during those recessions. It didn't happen this time. We simply moved into a standard private sector expansion with no bounce. California's pace of recovery in the aftermath of the Great Recession is highly dependent on the larger national economy. We begin with an overview of national trends. Then we turn to the specifics of California.

We are Bruised, But Still Optimistic

While economic data available to us at this writing have been disappointing, Beacon Economics sees an improvement in the pace of national real GDP growth. The data are in fact

mixed with some indicating a slowdown but others offer signs of modest acceleration in the national economy. Beacon Economics is less worried than others about the so-called fiscal cliff because we believe there is a natural mechanism that will prevent the issue from becoming a true stumbling block for the economy.

Importantly, both the Federal Reserve and the European Central Bank (which governs monetary policy in the euro-zone) have recently announced plans for large liquidity injections into their respective economies. This action is much needed in Europe, where fiscal austerity in the south requires some short-run countervailing force. The results are already clear. Interest rate spreads on Spanish, Italian and Portuguese debt over German bonds have come down sharply at this writing. Bond investors, in other words, are coming to believe that in one way or another, the EU will prevent default on the part of its weaker national economies.

As for the Federal Reserve's actions, Beacon Economics was – to speak candidly – a bit shocked by the announcement that the Fed would purchase $40 billion in mortgage-backed securities monthly for an indefinite period of time. We didn't consider recent trends in the U.S. economy sufficiently negative to warrant yet another round of such quantitative easing. Nor are we convinced that the action will have a major impact. In any event, there is already plenty of evidence that the real estate market is moving firmly into recovery mode.

Nonetheless, even if we have misjudged the Fed's actions, those actions can't hurt in the short run. We don't see any immediate inflation concern for investors despite the injection of added liquidity. But it is something to keep in mind for the medium term.

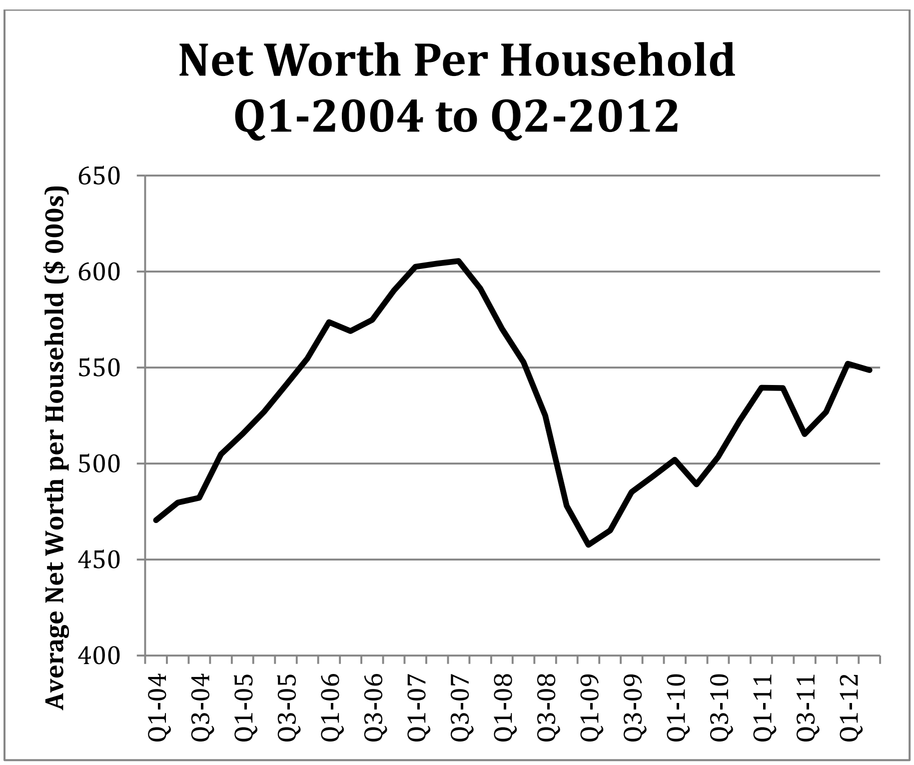
The Private Sector is Doing Fine

The private sector of the national economy at this writing is in the midst of a three-year expansion characterized by rising economic output, rising wages, improving asset values, and falling unemployment. Typically, growth in direct government spending adds roughly one-third of one percent to growth. But during 2011-2012, it has shaved two-thirds of one percent off overall growth per year. In other words, the public sector is the major reason why growth is one percentage point lower than normal overall. When we look at just the private sector, growth is more or less occurring at an average pace.

As for the source of private-sector growth, it isn't just consumer spending. Indeed, contributions from consumer spending have been slightly less than average, with the balance made up by greater-than-normal growth in spending on construction and business investments. This latter fact may be a bit of a surprise, since pundits have been repeating the mantra that businesses are afraid to invest because of excessive regulation, fears over healthcare costs, or the impending fiscal cliff. It simply isn't true – at least not according to the U.S. Bureau of Economic Analysis' measures of business investment as a component of GDP.

Even employment growth in the private sector looks decent. At this writing, we have seen a pace of growth in private sector jobs during 2011-2012, a bit faster than occurred over the past couple of decades. Unemployment remained above 8% until September 2012, but that is about 2 percentage points above the longer-term average. And it fell 2 percentage points in the prior two years. That trend is a normal pace of decline in unemployment for an expansion. Thus, the job trends suggest an economy on the mend, not in decline.

Chart 1



The most recent evidence at this writing indicates that corporate profits are at record high levels. Household net worth took a beating during the Great Recession but that measure, too, is showing recovery, as Chart 1 indicates. In short, it is hard for us to be pessimistic beyond noting that the recovery at the national level has been slower than one might have hoped initially.

The Euro-Zone Malaise

The economic weakness in the euro-zone is not helping the U.S. economy. Problems in Europe have caused the value of the U.S. dollar to rise which cuts into American exports by making our products more expensive in euro prices. Moreover, the weak demand for imports by Europe is having a negative effect on the global economy. But even here the risks may be overstated. Although the leaders of Europe have shied away from taking dramatic steps to reverse the course of their slowdown, they have shown resolve in the face of immediate challenges.

At this writing, we note that the European Central Bank announced plans to start large purchases of government debt, an act that is intended to push interest rates down for those southern nations at the heart of the crisis. An injection of liquidity can do much to offset some of the strains, both by reducing the interest rate burdens for nations running fiscal deficits and by giving the large European banks some breathing room in order to continue to buttress their balance sheets.

The risk of default by some of the weaker European countries on their bonds is receding. Thus, the danger of an imminent financial panic seems also to be fading, since the risks are understood by investors. The euro-zone remains a wait-and-see situation. Nevertheless, while export growth to Europe has slowed for the United States, exports are nonetheless still increasing.

Stumbling Along the Edge of the "Cliff"

Readers of this chapter will likely know the outcome of Congressional and presidential action on the so-called "fiscal cliff." But in our view, there really never was a literal "cliff." On January 1, 2013, the United States will see a sharp increase in taxes and a large decline in federal spending *if* the two parties cannot agree on a budget compromise. The overall shock to the

system would amount to roughly $550 billion, or $410 billion in tax increases and $140 billion in spending cuts over the course of the year. The impact would be an enormous shock that could carry a recession-causing force. But this shock does not mean that a recession – if no deal is reached by New Year's Day – will begin as of January 2.

The shock to the country would be substantial, but only if this budget remained in place for a sustained period of time in 2013. In other words, the cliff is really a fiscal hill, where – if not averted – we start to move slowly but pick up (downhill) speed over time. If the shutdown of the federal government in the 1990s under then-House Speaker Newt Gingrich is anything to go by, the political pressure on politicians to find a compromise will grow exponentially once the checks stop arriving and the tax bills start piling up.

Both political parties know what it will mean for them if they are viewed as the obstruction to a deal. The Gingrich episode suggests that consequence would be a potential clean sweep for the other side in the mid-term elections in 2014. We predict that even if there is no agreement by the deadline, some compromise will be reached in time to avert a major crisis.

Could a crisis occur, despite our logic? Politicians have charged like lemmings off the cliff in the past but we think it's unlikely to be the pattern this time. The short-run solutions are too easy.

Of course, any short-term discussion ignores the long-term issues facing the U.S. government deficit. The Congressional Budget Office recently released some truly startling projections of a blown-out federal government budget… but for the late 2020s. However, at this writing, the U.S. economy is showing signs of strengthening and there will be time to address these issues once the healing is complete. If we are wrong in our expectation about a compromise being reached on the fiscal cliff/hill, readers should adjust (downward) our forecasts for both the U.S. and California.

The California Outlook: Overview

In the quarters preceding this writing, California had largely escaped the doldrums seen in the rest of the nation. Based on that performance, we believe that the state is poised for continued growth, although the pace of recovery will continue to leave something to be desired.

We see a pace of job growth in the state running at around 2% per annum into 2013, before picking up steam and growing by between 2.5% and 3.0% per year from 2015 through 2017.

Taxable sales in California – a proxy for consumer demand – posted their twelfth consecutive quarterly increase in the second quarter of 2012, the latest figure we have available. And California has consistently outpaced the U.S. economy on that front. Beacon Economics is forecasting that taxable sales will grow by an average of 7% during 2013. We expect growth in such sales to settle out in the 5% to 7% range in nominal terms in the longer term.

Real estate has finally begun to add to the state's economy rather than detract from it. Beacon Economics expects home prices to grow at roughly 5% in 2013, before settling out in the mid-3% range in 2016 and 2017. Exports from California continued to increase in 2012, albeit with signs of slowing.

California's Labor Market

It's true that California's labor markets have not sprung back to life in the wake of the current recession, certainly not in the manner experienced in the post-recessionary periods of the 1980s and prior. Unemployment in the state has remained higher than the national average; California at this writing had the third highest unemployment rate of any state. However, California is not on the brink of disaster.

Even though job growth at this writing was not anything to get excited about, job creation actually has looked good compared to other states. This fact may be hard to believe, given that we are constantly bombarded with rhetoric claiming that California's business climate is unfriendly and business-killing. Even the national media took note of this strength with headlines such as, "California Defies Lower-Tax Texas in Creating More Jobs."[1]

Table 1 below shows the employment trends we had available at this writing. Most of the private sector showed respectable growth rates with the notable exceptions of farming and manufacturing. The public sector has been shedding jobs in response to the delayed impacts of

[1] James Nash and Darrell Preston, "California Defies Lower-Tax Texas in Creating More Jobs," *Bloomberg News*, August 28, 2012. Available at http://www.bloomberg.com/news/2012-08-29/california-defies-lower-tax-texas-in-creating-more-jobs.html.

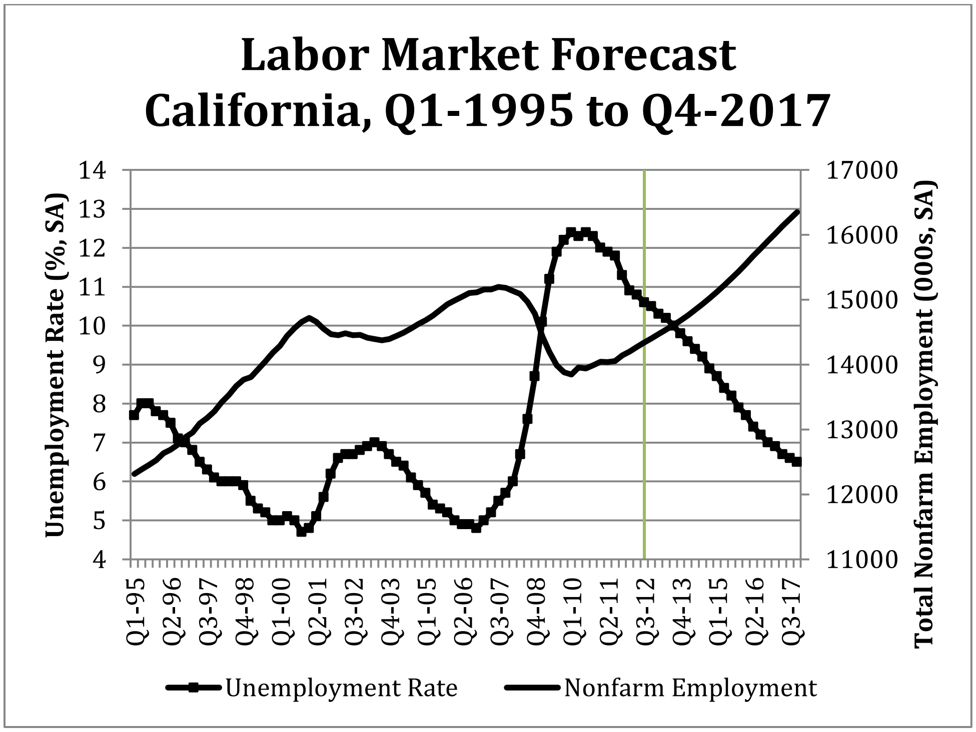
pressure from distressed state and local budgets. Even the construction industry – hard hit by the housing bust – has been expanding.

Table 1

California Employment by Industry Sector				
Industry Sector	Aug. 2011 (000s)	Aug. 2012 (000s)	Change (000s)	Change %
Education/Health	1,839.7	1,897.2	57.5	3.1
Leisure/Hospitality	1,531.5	1,587.9	56.4	3.7
Administrative Support	873.4	925.0	51.6	5.9
Professional	1,057.5	1,105.8	48.3	4.6
Construction	547.8	580.8	33	6
Retail Trade	1,532.2	1,553.6	21.4	1.4
Information	432.7	452.6	19.9	4.6
Wholesale Trade	663.9	676.3	12.4	1.9
Finance/Insurance	515.0	526.9	11.9	2.3
Real Estate	244.7	254.4	9.7	4
Management	199.2	202.6	3.4	1.7
Transport/Warehouse	470.8	473.6	2.8	0.6
Other Services	484.7	485.3	0.6	0.1
Natural Resource/Mining	28.6	28.9	0.3	1
Farm	387.4	382.8	-4.6	-1.2
Manufacturing	1,250.9	1,243.9	-7	-0.6
Government	2,374.9	2,351.5	-23.4	-1
Total Private	11,672.7	11,994.8	322.1	2.8
Total Nonfarm	14,047.6	14,346.3	298.7	2.1

Clearly the labor markets in California are on the mend and the worst of the downturn is behind us. The Bay Area in particular has done well throughout the recovery. With most major industries and regions across the state solidly in growth mode, Beacon Economics is forecasting that California's labor markets will continue to improve in 2013 and beyond. Chart 2 summarizes our forecast. Unemployment is expected to fall into the 6-7% range by 2017. That's not stellar performance but it reflects the general pace of steady recovery.

Chart 2



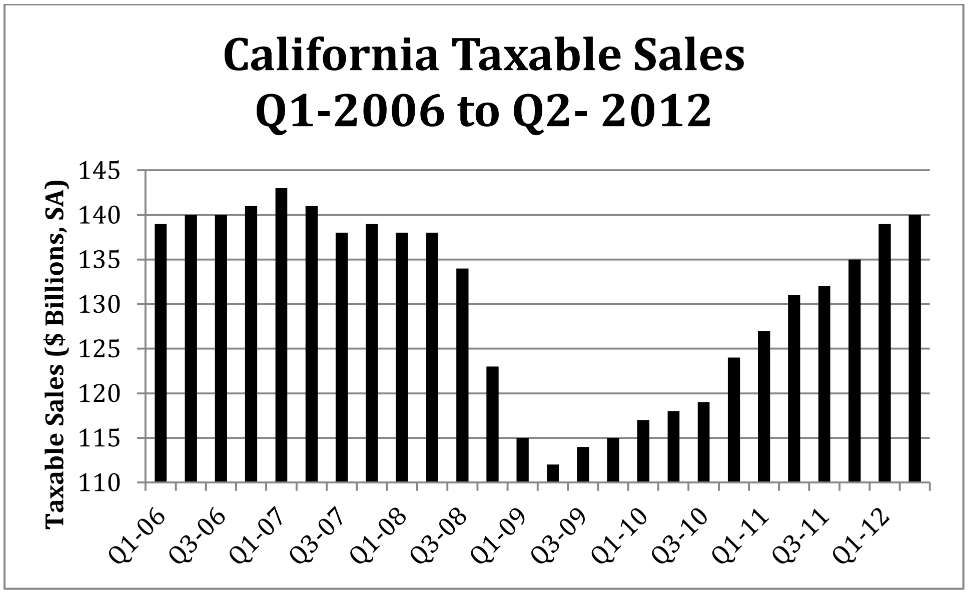
SA = Seasonally Adjusted.

Beacon Economics is forecasting employment growth to remain in the 2% range for 2013. At that rate, Beacon Economics forecasts that California will get back to its pre-recession employment peak of 15.2 million jobs by mid-2015. Bottom line: It will take time – several more years – for the state to return to "normal."

No Consumer Spending Slowdown

Chart 3 shows the latest figures available at this writing on taxable sales in California – a proxy for consumer spending. In percentage terms, there was a slowdown in growth in the second quarter of 2012. Nonetheless, California's taxable sales growth through that date had outpaced U.S. consumption of goods during the earlier two-year period. In other words, while some aspects of the economy, particularly the real estate and labor markets, have yet to recover fully in the Golden State, consumer spending is not an area that has been holding California back. Indeed, it was one of the stronger aspects of the economy, helping to move the state forward at a faster pace than seen in the U.S. overall.

Chart 3



SA = Seasonally Adjusted.

Breaking this spending down by category reveals that California was not experiencing isolated pockets of improvement but rather broad-based growth. According to sales tax auditing firm HdL Companies, sales tax receipts across the state were up in every single spending category. (See Table 2.) In addition, the growth was evenly split between spending by consumers (up 7.5% on a year-over-year basis) and spending by businesses (up 7.1% year-over-year). On the consumer side, auto sales have contributed significantly to this growth, increasing by more than 17% over the second quarter of 2011.

Table 2

California Sales Tax Receipts			
Category	*Q2-2011 ($ Millions)*	*Q2-2012 ($ Millions)*	*Change*
Consumers	1,094.0	1,176.5	7.50%
- Autos/Transportation	163.4	192.2	17.60%
- Restaurants/Hotels	151.2	164.2	8.60%
- Food/Drugs	75.5	79.8	5.70%
- Building/Construction	91	95.4	4.80%
- General Consumer Goods	296.6	308.4	4.00%
- Fuel/Service Stations	177.9	181.6	2.10%
Business/Industry	192.2	205.8	7.10%
Total	1,286.20	1,382.30	7.50%

Source: HdL Companies

The boost in auto sales is not surprising, given the surge in auto sales nationwide and the fact that growth in California had been outpacing the rest of the United States. Still, surprising or not, this segment of sales represents a critical trend insofar as it provides much-needed sales tax revenues to state and local governments. It's also a bellwether, signaling that consumers are feeling optimistic enough about the economy to make these long-term durable goods purchases. The auto sale growth provides solid evidence that the California consumer was feeling better about the prospects for the future.

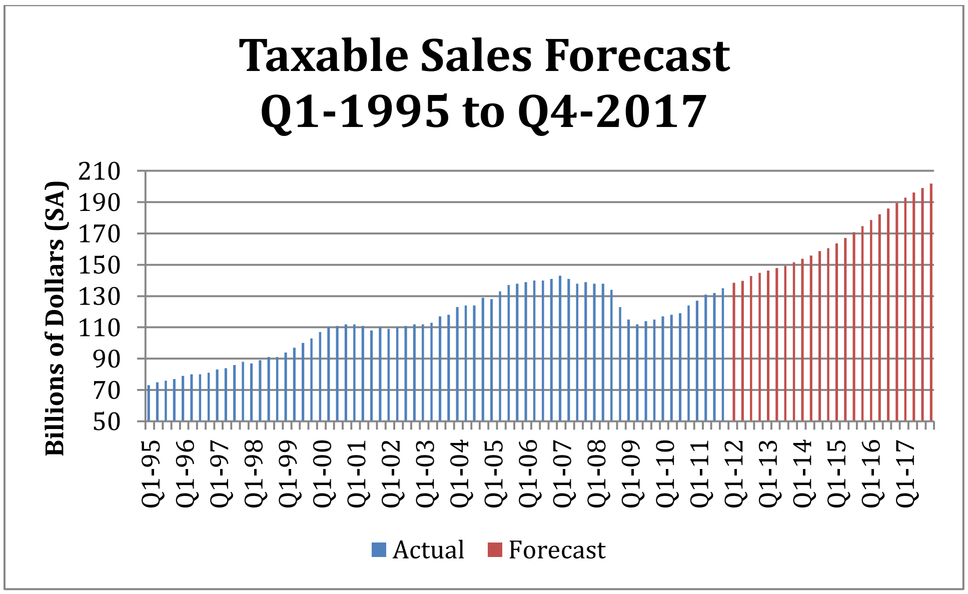
However, the rebound in spending in the state has not been limited to auto sales. There was solid performance in both local and tourist spending across California in 2012. For example, sales tax receipts at California's restaurants and hotels were up more than 12% during the second quarter of 2012 over the same period in 2011. California is known for its diverse geography, idyllic climate, and popular destinations from Hollywood, to SeaWorld, to the Golden Gate Bridge. These assets are helping to bolster the California tourism sector. As Chart 4 indicates, hotel occupancy rates and room prices have been rising since hitting bottom in 2009-2010.

Chart 4

SA = Seasonally Adjusted.

As noted, all other sectors continued to perform well through the halfway mark of 2012. Year-over-year sales increases ranged from as little as 2.1% at gas stations to 5.7% at grocery and drug stores. Even the construction sector, which has long been a source of pain, has seen spending on building materials increase over the past few quarters. Obviously, some sectors are faring better than others, but – as far as data available at this writing goes – none of the state's major categories saw sales tax receipts decline in 2012.

Chart 5



SA = Seasonally Adjusted.

With the labor markets growing (albeit at a relatively tepid pace relative to the post-recession expansions of the 1970s and 1980s), and with the economy healing, taxable sales in California are poised for continued growth. We expect growth in such sales to settle out in the 5% to 7% range in nominal terms. In short, California is likely to experience solid growth in spending from 2015 to 2017 with the impact felt in state and local budgets through the receipts of sales tax.

Real Estate Pitches In

Over the period up to 2012, the real estate markets have been a drag on statewide economic growth in California. However, 2012 ushered in a new trend, where real estate began to add to the economy at large rather than detract from it. At this writing, according to real estate

tracking firm DataQuick, California home sales posted their fourteenth consecutive year-over-year increase in August 2012. They reached their highest level since December 2009, when the first-time homebuyer tax credits were drawing a significant number of new buyers into the market. Although these tax credits have since expired, Californians were in more of a buying mode by 2012 than they were in the period in which tax credits were available.

As labor market conditions improve and incomes rise, many California residents are looking to take advantage of record low mortgage rates and more reasonable house prices. (See Chart 6.) The cost of housing (home price, mortgage interest payments, etc.) is now more in keeping with household incomes again. In fact, the Federal Reserve reported that the average rate for a 30-year fixed-rate mortgage, at 3.55% in July 2012, was at its lowest level since the Fed began reporting on mortgage rates in 1971.

Chart 6

SA = Seasonally Adjusted.

The boost in demand for homes in California has also contributed to house price appreciation in the state. Since hitting bottom in April 2009, the median price of a home in California was up more than 24%, from a low of $221,500 to over $275,000 in August. Helping

this trend is the fact that distressed mortgages in the state continue to dwindle and represent a smaller share of the overall sales mix.

In fact, Radar Logic reports that over the summer of 2012, distressed sales fell to their lowest share of home sales in over four years.[2] The Mortgage Bankers Association corroborated these statistics, showing that only 7% of California mortgages were seriously delinquent (60+ days past due) or in foreclosure by the second quarter of 2012. This level of delinquency was down from a peak of almost 14% and represented the lowest share of distressed properties in the state since early 2008.

The growth in home prices was not distributed evenly across the state. Between the second quarter of 2011 and the second quarter of 2012, price growth for existing single-family homes ranged from as much as 7.9% in the South Bay to no growth in Modesto. The coastal areas in northern and southern California did well, but that growth also spread to the inland areas, including the East Bay, the Inland Empire, and the Stockton metropolitan statistical area (MSA). All of those areas saw year-over-year increases in median home prices in that period. Importantly, only a few smaller MSAs, including Hanford, Napa, and Yuba City, posted year-over-year declines in home prices.

Beacon Economics is forecasting continued improvement in the local housing market. Home sales, which have bounced back steadily over the last year, are expected to continue to climb slowly at first, as we have already seen a solid bump. But we expect a picking up of speed in 2014 and 2015. By 2017, home sales are expected to level off, with 90,000 to 100,000 transactions per quarter.

Home prices are expected to continue to rise as well, although this time they will likely rise in line with incomes. This trend will mean slower growth than we experienced during the bubble, but the growth will be sustainable this time around. Specifically, Beacon Economics expects home prices to grow at roughly 5% in 2013, before settling out in the mid-3% range in 2016 and 2017.

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[2] Tory Barringer, "Radar Logic: Share of June Distressed Sales Lowest Since 2008," *DSNews.com*, August 28, 2012. Available at http://www.dsnews.com/articles/radar-logic-share-of-june-distressed-sales-lowest-since-2008-2012-08-28.

Chart 7

SA = Seasonally Adjusted.

In terms of new construction, at this writing we've already begun to see an uptick in both residential and nonresidential permitting. Fortunately for the construction outlook, unlike many other states, California still does not have enough housing. This fact is evident in the cost of housing. California has a much higher share of residents spending more than 35% of their incomes on housing relative to the national average. It is also evident when you look at housing vacancies in the state. Despite all the construction that took place during the bubble, California still maintains one of the lowest housing vacancy rates in the nation, particularly on the *rental* housing side of the market.

In the commercial real estate market, vacancy rates have begun to come down across the state for retail, office, and industrial properties. At the same time, rents have begun to inch upward. In addition, the bump up in construction activity has increased construction employment in the state solidly over the past few months.

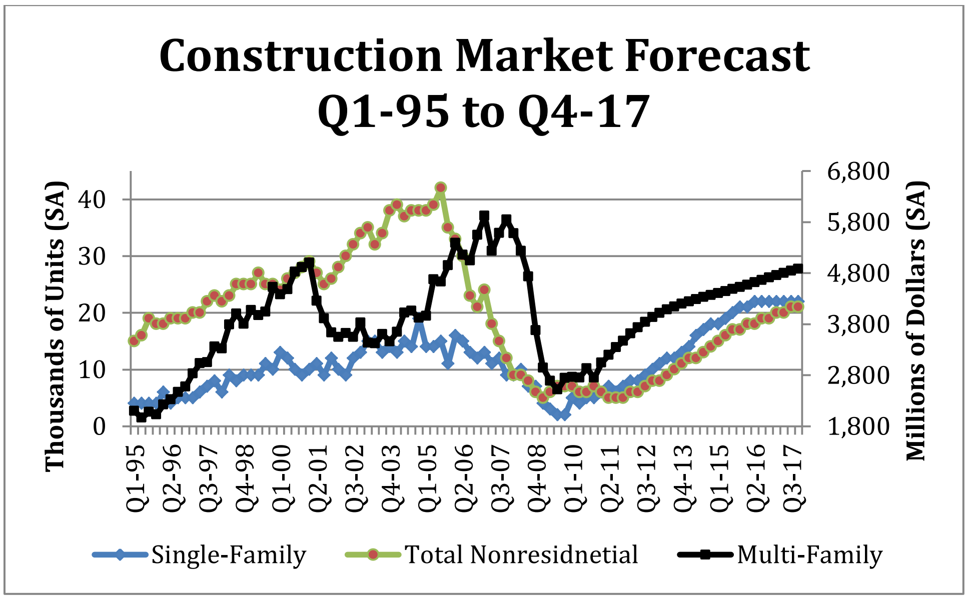
As a result, Beacon Economics expects both residential and nonresidential construction to continue to increase as the recovery progresses.

The residential market is expected to experience a bit of a shift, with multi-family permits accounting for a larger share of overall residential housing moving forward. Nonresidential permitting, which has been concentrated in building alterations of late, is expected to improve as

well. A larger portion of those permits will be moving toward new structures rather than alterations as firms begin to feel better about their opportunities for growth and expansion.

Neither residential nor nonresidential permits are expected to go back to the heights reached during the bubble. But the upward trend will continue. We expect roughly 40,000 new residential units this year, with that number increasing to 85,000 units in 2013 before hitting 100,000 units in 2014.

Chart 8



SA = Seasonally Adjusted.

California weathered one of the worst real estate storms in recent history during and after the Great Recession, but there is more than a ray of light on the horizon. Home sales and prices have started to rebound and permit activity is picking up. The commercial markets have begun to improve and broader economic conditions point to a continued recovery in the state. As such, the Beacon Economics forecast calls for more improvement in California's residential and commercial real estate market as we enter 2013 and beyond.

Exports Still Growing

The problems bubbling over in Europe of late have given rise to fears of a major contraction in U.S. exports. In California, export growth has slowed from the double-digit growth that we experienced in 2010 and 2011. However, exports have continued to increase in

2012, albeit at a more tepid pace. As Table 3 shows, through July 2012 (the latest data available at this writing), California's exports were roughly 5% higher than they were at the same point in 2011. While this performance cannot be considered a massive increase, it represents ongoing growth nonetheless.

Table 3

California Exports		
Country	July 2012 YTD	Change % (YTD 2011-2012)
Mexico	16,376	17.57
Canada	9,907	2.14
China	8,182	0.46
Japan	7,728	1.13
Korea, Republic Of	5,228	4.13
Hong Kong	4,458	5.28
Taiwan	3,676	0.61
Germany	2,905	-7.12
Netherlands	2,620	-2.16
United Kingdom	2,528	6.05
Total	95,052	5.11

YTD = Year to Date.
Source: Wiser Trade

Even though the headline numbers show slower growth, several sectors continued to do rather well. Take agriculture as a prime example; exports of live animals, fruits and nuts, and dairy products have increased by 17.6%, 16.2%, and 13.1%, respectively. In addition, our manufactured goods have held their ground relatively well with aircraft/spacecraft exports up 11.5% while railway equipment has increased by nearly 13% to date in 2012. California vehicle exports are also on the rise, with more than $4.3 billion sent abroad so far this year, for a 9.8% increase over 2011. Thus, even though state export growth has slowed, export expansion continues to move forward.

It is also important to keep in mind that export growth has slowed in part because we are catching up to our historical trend lines. Because exports took a big negative hit in 2009, part of the accelerated growth we experienced in 2010 and 2011 was a catching-up effect. The earlier pace, however, could not be expected to persist indefinitely.

It is also important to point out that although the euro-zone continues to be in the midst of a financial ordeal, Europe is neither our only trading partner nor our largest. Our largest trading partners are our North American neighbors in Canada and Mexico. Importantly, exports to Mexico in particular have held up well, posting 17.6% growth at this writing in 2012 compared with the same point in 2011. In addition, of our top ten trading partners here in California, exports have only dipped into the negative with respect to two of them: Germany and the Netherlands. Even exports to the United Kingdom have gone up this year. Therefore, while Beacon Economics is not expecting export growth in California to take off in 2013, exports should continue to move along at a modest but positive pace.

Summary

Overall, California has had a bumpy ride down the path to economic recovery after the Great Recession. But it has made significant progress in that direction. Employment growth has been relatively consistent, with California jumping ahead of the rest of the nation at this writing. Consumer spending, real estate, and exports all continue to move forward. And California has led the nation in some of these important areas. We still have a long way to go before we can declare the state fully recovered from the Great Recession and its aftermath. However, the fundamentals of California's economy are improving and are expected to continue to do so in 2013 and beyond.

CHAPTER 8

California Political Forecast 2013: The Unsinkable Jerry Brown, Act 3, Scene 2

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"Desires are endless. I vow to cut them down."

A Zen mantra quoted by Gov. Jerry Brown
shortly after the 2012 election[1]

"At this stage, as I see many of my friends dying, I want to get shit done. And I'm going to get this done. All right?"

Gov. Jerry Brown unveiling a
$14 billion delta water bypass, July 2012[2]

For the past decade, the story of government in California has been a series of bleak tales of budget deficits, partisan gridlock, and public distrust of politicians, especially in Sacramento. But starting with the 2010 election and culminating in 2012, a confluence of forces – voter passed reforms, demographic shifts, a moderately recovering economy, and the political acumen of the governor – has created some hope that California just might be governable after all.

The Democrats' Supermajority

With one party having a supermajority in the state assembly and the senate, after the November 2012 election, gridlock is unlikely to be the problem it has been in the past. And with the passage of Propositions 30 and 39, which will provide about $7 billion in new revenue from hikes in sales and income taxes, plus eliminating a multi-state corporate tax break, the state budget suddenly seems manageable. Redistricting by a citizens' commission and new primary rules that allow for the two highest vote-getters to run against each other in general elections, both passed by voters in 2010, seem to have resulted in the election of more moderate legislators. A relaxing of term limits, also from 2010, should yield more experienced and congenial lawmakers. Finally, the aura of sagacity and frugality currently emanating from the governor's office has lifted public trust and provided a measure of assurance that Democratic control of the legislature will not simply result in a binge of taxing and spending.

Problems Remain

But it is a precarious equilibrium. The state and its local governments are still faced with escalating pension, health care, personnel, and capital costs. The economy is still sluggish. Small

businesses resent government. Cities need to rebuild infrastructure to support economic growth. The climate is changing. Water management is inadequate. The public school system is still strapped. Higher education is threatened with decline. Prisons are overflowing and the release of prisoners to counties and parole could have adverse effects. And the economic divide is widening, leaving the poor, the working poor, people with disabilities, and educated and able young adults looking for jobs and in debt.

A Divided Electorate

The California electorate is still divided, but it is changing. Democrats and Republicans have become more polarized, with 52% of Democratic voters calling themselves liberal (up from 46 % in 2000) and 70% of Republicans calling themselves conservative (up from 58% in 2000). Independent voters, who tend to vote Democratic by a 2-1 ratio, have increased to 21% of the electorate (up from 14% in 2000). Young voters, between the ages of 18 and 35, make up 27% of the electorate. Latinos make up 20%, and while they tend to be socially conservative, they are still wary of Republicans, a legacy of the Proposition 187 campaign.[3] Women, who make up 51% of voters are more likely to be registered as Democrats than Republicans, 50% to 30%.[4] But perhaps the most striking statistic of all, only 29% of California voters are registered as Republicans.[5]

Indeed, Proposition 30, the governor's tax initiative, was carried by Latinos, Asians, African Americans, women, lower income, and independent voters. Younger voters, 72% of whom supported it,[6] led the way, largely undetected by the pre-election political radar. At the center of this hopeful, precarious, divided, and changing state – following the dramatic results of the 2012 election – is the governor.

Governor Jerry Brown

As the smoke from hundreds of millions of burned campaign dollars clears from the 2012 California state election, the governor, Edmund G. Brown, Jr., 72, in the probable final act of a remarkable political career, stands alone. His Proposition 30, which featured him prominently in commercials, passed by a comfortable 54%. He vanquished a well-financed alterative proposition (Prop 38) put forth by heiress and activist Molly Munger. The voters rejected Proposition 32 – a so-called paycheck protection initiative – that would have disqualified much

of his party’s union-driven contributions. Brown’s party has full control of the legislature for the first time since 1883. And while bills originate in the legislature, as a governor he has the power of veto and line-item veto, although in theory his party could override a veto.

Early History

Ambitious, solitary, perspicacious, mystical, and frugal, Jerry Brown has charted an incomparable political course via an uncanny ability to be at both the edges and the center of the political circle at the same time. The son of former governor and Democratic icon Pat Brown, Jerry Brown was first elected to public office as a member of the Los Angeles Community College Board in 1969. In 1971, he ran for Secretary of State and built a reputation going after corporations for campaign finance fraud. He was first elected governor in 1975 on a wave of post-Richard Nixon/Watergate scandal distrust of Republicans.

Brown’s First Governorship

In Act 1, young Governor Brown was seen as smart and brash; a former Catholic seminarian, Berkeley and Yale Law school graduate, with an unusual reputation for tough prosecutorial stands, opposition to the death penalty, and fiscal conservatism. He also had an ethereal connection to a New Age counter-cultural intellectual vibe that, coming out of the 1960s, had begun to view California and the world as an ecological system to be engineered rather than exploited.

Only one heady year into his governorship, Brown ran for president and finished third in convention delegate count behind Jimmy Carter and Mo Udall. He ran again for president in 1976 on a platform to “protect the earth, serve the people, and explore the universe.” Brown inspired independents and younger voters seeking an alternative to Edward Kennedy’s robust machine liberalism and Jimmy Carter’s trusted but anemic presidency. But he also invited derision for his “Governor Moonbeam” persona, a term that first surfaced in a *Rolling Stone* interview with his then girlfriend, the winsome songstress Linda Ronstadt. Brown did better the second time around, but again finished third in the primary season.

At the end of his second term as governor (full disclosure: I worked in the Governor’s Office of Appropriate Technology promoting alternative energy and hazardous waste disposal

technologies, 1981-1982), Brown ran for the U.S. Senate. But, as he aptly described to staffers on election night, the people of California seemed to have grown tired of him, and, truth be told, he had grown tired of them. (Full disclosure: I voted for author Gore Vidal over my boss in the primary.) Brown lost to San Diego Mayor Pete Wilson in the general election.

End of a Career?

"Is it now time to wave goodbye to the remarkable career of Governor Jerry Brown at the ripe young age of 43, when most other politicians are just starting to move up the political ladder?" wrote Ed Salzman in *The California Journal* in September 1981. "Yet, there is a certain hesitance in the voices of those performing the preliminary rites over Governor Brown. Isn't this the same Jerry Brown who has shown a remarkable streak of luck during his hectic political career? Isn't this the Brown who has a Houdini-like capacity for escaping unscathed from the tightest political bindings, emerging in stronger condition than before?"[7]

Brown sauntered off the political stage and entered a period of five years in Zen-inspired introspection, spending time in a Christian Zen monastery in Japan and working with Mother Theresa in Calcutta. In 1988, Brown returned to California politics and ran for chairman of the state Democratic party, which he won and proved to be a surprisingly effective fundraiser. He announced a run for the U.S. Senate in 1992, but abandoned it to run yet again for President. This time, he was able to ignite a populist following in states such as Maine, Colorado and Vermont behind a strategy of only accepting small donations though an 800 phone number and campaigning for flat tax. But he was quickly eclipsed in the race, first by Massachusetts Senator Paul Tsongas and then by Arkansas Governor Bill Clinton. Again, the pundits wrote Brown's political obituaries, but, in retrospect, it turned out to be only the end of a very long Act 1.

The Return to Elective Office

Act 2 began with a surprise. In 1999, Brown announced that he was running for mayor of Oakland as an independent candidate, denouncing the corruption of the two-party system. He was elected and served two terms, where he focused on downtown business development and anti-gang initiatives. He then returned to the Democratic Party in 2007 to run for state attorney general. Brown was elected in a landslide, and served for four years publicly focused on such issues as opposing death penalty cases and predatory lending, and favoring same-sex marriage.

He did not so much run for governor in 2010 as offer himself to the voters as a matured and experienced old hand at California politics, promising both to make cuts and seek tax increases. However, for the latter, he promised no tax increases without the direct approval of California voters through a ballot proposition.

The transformation of Act 2 was underway, prompting *San Francisco Chronicle* columnist Chip Johnson to write:

> Just like Elvis, Brown's "Moonbeam" persona has left the building. He's been replaced by Edmund Gerald Brown Jr., the son of former Gov. Pat Brown. At 71 years old, Brown has an approach that indicates a well-grounded understanding of the challenges facing the state.
>
> What Oakland residents saw in Brown for eight years as mayor, the rest of the state is now about to see: More than 30 years after his first gubernatorial term, after three presidential runs and a stint as a radio talk show host, Brown is a seasoned politician whose policies resemble those of a fiscally aware conservative.
>
> In two terms as mayor and one as the state's attorney general, Brown has been among the more pragmatic politicians in the Bay Area. He is more apt to announce a crackdown on crime or rail on the state's probation and parole system than offer ideas on how to cure social ills.
>
> As mayor, Brown was Oakland's chief spokesman and an ambassador for development. He also ignited a redevelopment effort in the city's downtown district that succeeded in attracting 10,000 new residents.
>
> During those years, he sponsored nearly two dozen crime initiatives in an attempt to reduce the city's crime rate.
>
> For some supporters in the first mayor's race, the change in Brown was so dramatic that some not only felt betrayed, they soon didn't recognize the man they had elected.
>
> His tough stance on crime, coupled with his embrace of commercial and real estate development, was a far cry from his younger, idealistic visions of social and political change.[8]

Back to the Governorship

In the race for Governor, Brown defeated Republican Meg Whitman, a respected businesswoman who outspent him $177 million to $36 million, by a margin of 54% to 41%. After the election, in his inimitable style, Brown told an audience of business leaders:

"Aristotle's poetics talks about three acts—the beginning, the middle, and the end. We're just beginning Act II. It's true some politicians don't have a third act. I hope I'm not one of them, because the third act is when it gets good. Act II is when the protagonist is under pressure to get out of the box he's in. You wait. We're going to get to Act III very soon."[9]

Fiscal Concerns

The box, of course, was the fiscal crisis the state was in, and its walls, at least from a Democrat's perspective, consisted of the handful of Republican legislators empowered by the two-thirds majority needed to pass any tax increase**.** Brown's formula – solvency can only be achieved through a combination of budget cuts and revenue increases – could not be achieved through a divided legislature. At first Brown tried across the aisle reasoning, but it didn't work. Republicans would not provide the needed two-thirds vote in the legislature to put the tax issue before the voters.

Having failed to persuade Republicans to cooperate, Brown crafted, with some polling and focus group research, a ballot referendum that would increase the sales tax by a quarter of a cent on the dollar, raise the income tax rate on the wealthy, and target the new revenue to education. If the voters didn't pass it, he vowed to follow through on a raft of draconian, ugly cuts to schools, community colleges, and state colleges and universities. It was entitled: "Temporary Taxes to Fund Education. Guaranteed Local Public Safety Funding. Initiative Constitutional Amendment," Proposition 30. For Jerry Brown, it would mark the beginning of his Act 3.

The 2012 Election

In a pre-2012 election interview with independent journalist Mark Cooper, Brown explained: "California is living beyond its means. And we always have a crisis. We had a crisis in '07, '03, we had a crisis in the '90s, the '80s – they were crises and we called them recessions. Because the states can never build up a reserve … and once they're in the hole, then they have to use borrowing and gimmicky accounting maneuvers. What I'm saying, after a hiatus of 27 years, is that I want to get on a firmer path, and that means the revenue you take in should be enough [to cover] the revenue you spend, and go beyond that to get a reserve. In order to do that, we need cuts and pension reforms, and taxes. And if we don't get taxes, we'll need more cuts. It's

not a liberal agenda. It is an agenda of common sense that I believe the vast majority of people will agree with."[10]

At first Proposition 30 polled well. But as the election grew near, support for Proposition 30 seemed to wane, at least as the major polls reported the trend. The third act for the governor was starting to look like just another tragic reprise of deficit, gridlock and dysfunction. But on Election Day, bolstered by a stronger than expected turnout by Latinos and younger voters, as well as a redistricting that favored Democratic candidates, Proposition 30 passed by a healthy 54-46 percent margin. And the minority party's hold on the legislature was also broken as Democrats gained enough seats to exceed the various two-thirds supermajority rules.

For Jerry Brown Act 3 began on Election Day, 2012. In a post election press conference, he said: "Voters have trusted the elected representatives, maybe even trusted me to some extent, and now we've got to meet that trust. We've got to make sure over the next few years that we pay our bills, we invest in the right programs, but we don't go on any spending binges." And then he recited a Zen mantra: "Desires are endless. I vow to cut them down." [11]

Act 3, Scene 2: Sticking to the Script

In Sacramento, the 2013 legislative agenda will be shaped and negotiated by three players: Governor Brown, Senate President Darrell Steinberg, and Assembly Speaker John Pérez. Immediately after the election, Brown dismissed conservative speculation that he and the legislature would seek to raise taxes further to make up for deep cuts incurred in social programs and education. He reiterated his pledge that he would veto any tax hikes and stick to his campaign promise that no tax increases would happen without the direct approval of voters. Brown's priorities, he said, were 1) push the California High Speed Rail Project, 2) pass and fund a plan to bring more water from the Sacramento-San Joaquin river delta to southern California, 3) seek regulatory relief to spur business development, enact state budget reforms and fixes to improve California's bond and credit ratings, and 4) increase local control and accountability for education.[12]

For their parts, Senator Steinberg and Assemblyman Pérez mainly echoed the governor's commitment to frugality and not raising taxes. Steinberg did raise the possibility of pursuing tax reform (by "broadening the base . . . lowering rates, creating a more competitive environment for

business, and potentially bringing in more revenue") as well as an unspecified "reinvestment" in higher education, K-12 education, and human services.[13] And Pérez told the press "The governor's been very clear that the only way to do taxes as long as he's governor is through a direct vote of the people. We're not looking to figure out new ways to do things that we've said we're not going to do." Pérez did, however, pledge to revive his proposal to create new university scholarships for middle-class Californians.[14]

In other words, the governor, the senate president, and the speaker of the assembly, all newly confident of their power to move legislation and seriously committed to prove fiscal responsibility, have wish lists. Their goals are both expensive and fraught with potential difficulty, even within the Democrats' new supermajority. Let's look at the two major issues on the Governor's agenda, high speed rail and the delta water project.

California's High-Speed Rail Project

In recent decades, many U.S. visitors to China, Japan, Germany, France, Italy, and Spain have returned enamored with the idea of high-speed rail. Both Governor Brown and President Obama are proponents on the grounds that high-speed rail construction will stimulate state and local economies, as well as provide a cleaner, more efficient alternative to car and jet travel. The plan backed by Brown in California called for a $46 billion project, the California "Bullet Train," which would run from San Diego to San Francisco and Sacramento. When completed in 2028, estimated train time from Los Angeles to San Francisco would be two hours and 30 minutes. In 2008, on the same day Obama was elected, California voters approved a $9.5 billion bond measure to begin construction on a high speed rail project. And since then, the Obama administration has allotted over $3 billion to California for the project (including $2 billion from the federal stimulus turned down by Florida for a proposed high speed rail project there).

After the initial enthusiasm, however, the Bullet Train has lost support. The cost of the train is now estimated to cost in the neighborhood of $65 billion.[15] During the Proposition 30 debate, the Bullet Train was held up as an example of an unnecessary, wasteful expenditure by opponents of the measure. Some Proposition 30 supporters, in fact, advocated that Brown drop support for the Bullet Train as an assurance that state government was serious about budget

cutting. A June 2012 USC Dornsife/Los Angeles Times poll showed that 55% of voters wanted the high-speed rail back on the ballot and that 55% would oppose it.[16]

Leading environmental organizations have also opposed the proposed rail project. Some researchers in the urban planning community fear that the train will cause more suburban sprawl. In July 2012, the legislature appropriated $4.5 billion from the high-speed rail bond measure. But the margin of victory in the Senate was razor thin with a number of Democrats opposed.

To reach his first third-act objective, Governor Brown has to persuade legislators and voters that public-private partnerships can come up with the additional $50 million-plus needed to complete the rail project. And he needs to show that the train's long term benefits outweigh the steep costs. In the legislature, it is likely that support for high-speed rail, as it did in the 2008 referendum, will tend to run, not by party affiliation, but by proximity to the routes. Additionally, as the federal government moves to cut domestic spending as part of deficit-reduction, the California delegation will have to protect current and future allocations to high-speed rail nationally and to California in particular.

Delta Water Project

In the 1960s, then-Governor Pat Brown oversaw the construction of a 2,100 mile chain of dams, reservoirs, pumps, and aqueducts to transport water from the snow mass in the northern mountains to the farms in the Central Valley and the Los Angeles basin. But the main juncture of the system, the Sacramento-San Joaquin Delta, has been seen as the weak and wasteful link. Among its most obvious problems, its levees aren't adequate to prevent salt water flooding in the event of a major earthquake, or by rising oceans due to climate change. The massive pumping system on the south side is harmful to fish, and, by extension, to the fishing industry along the coast.

One solution to those problems would be the construction of a peripheral canal or series of tunnels that could divert fresh water around the delta, coupled with engineering to restore the Delta's ecosystems. But the diversion has been a very difficult sell. Jerry Brown fought unsuccessfully for the peripheral canal in his first terms as governor. Bond measures and referendum questions have been proposed in the legislature but have faltered because they didn't please enough stakeholders.

In an effort to gain the two-thirds votes needed for putting a bond measure on the ballot, supporters had to please too many stakeholders with side deals, making the proposed measure too expensive to pass muster with California voters. In July, after the legislature shelved a $11 billion water bond measure, Governor Brown and U.S. Interior Secretary Ken Salazar unveiled a blueprint for a $14 billion system of tandem underground pipes and environmental repairs that address the system's limits and vulnerabilities.

To achieve his second major Act Three objective, Brown faces an uphill political battle very much like the water wars he had faced in the 1970s and early 1980s. Most of the cost will be borne by ratepayers at a predicted rise of $6-7 per household.[17] Northern Californians see the project as a water grab for the south. Delta area farmers stand to lose both water and land by eminent domain. The environmental community is divided on the issue, but generally believes that much more can be accomplished by conservation mandates and technologies and water recycling.

Still, Brown is insistent. At the unveiling press conference, Brown explained: "Analysis paralysis is not why I came back 30 years later to handle some of the same issues. At this stage, as I see many of my friends dying, I want to get shit done. And I'm going to get this done. All right? We are not going to sit here and twiddle our thumbs and stare at our navels."[18]

And Brown has power as a result of his Proposition 30 victory. As *Los Angeles Times* columnist George Skelton wrote:

> When the nation's framers wrote the Constitution, they designed a republican form of democracy in which public policy was supposed to be decided by elected representatives. But in a 2010 campaign stunt, Brown promised voters "no new taxes unless you, the people, vote for them."
>
> Brown thus surrendered much of his power. And in asking for the voters' approval to raise taxes, he broke a rule any trial lawyer learns early: Don't ask a question unless you already know the answer.
>
> But the wily old pol pulled it off, despite being criticized by many – myself included – for offering mixed, often disingenuous messages.
>
> Brown did it his way, the risky way, the agonizing way – if not the way the framers would have wanted. But it was the winning way and, in the end, surprisingly, not even close.[19]

Things to Come

Going into the 2012-13 legislative session, Governor Brown understands that the conflict will be between boldness and pragmatism. Some legislators and voters will want to spend and invest for the future; some will want to continue to pay down the state's debt and save. There is also much that an un-gridlocked legislature can do short of raising taxes that would have major effects on governance.

The senate president has spoken of tax reform. One could imagine a lowering of the sales tax, which voters would like, making up for it by broadening the tax base to include taxes on services, such as laundry and childcare, which are currently exempt. The senate president would also like to reform the initiative process by giving the legislature, once signatures have been collected, a shot at solving the problem in a deliberative way before it goes on the ballot. Another reform would be to put a time limit on voter-passed constitutional amendments, say 15 years. At that point, they would have to be considered again and the legislature would have the opportunity to explore a new solution.

The legislature might also want to take a shot at reforming some of the more dubious consequences of Proposition 13. For instance, many corporations have been able to avoid having their properties reassessed at sale, as is required for homeowners and small businesses. Having multiple shareholders or the company retaining its name on properties allows many businesses, in terms of tax law, to avoid reassessment and higher taxes, unless, say, a single individual buyer holds 51 percent of the company.

This tax law anomaly is why, for instance, former Dodger owner Frank McCourt owns 49, not 51 percent, of the Dodger Stadium parking lot. The remaining portion of the lot is owned in smaller percentages by others. The property was not reassessed when he first bought the Dodgers, nor when he sold the Dodgers and retained the parking lot. The Dodger stadium parking lot is taxed, with incremental increases, based on the 1978 value of the land.)[20]

A "split roll" reform, which the legislature (or an initiative) would still have to put on a ballot, could fix that. But there are various versions of the split roll concept that would need consideration. The details in such proposed reforms matter.

Beyond impulses for ballot propositions and tax fixes, many legislators will want to be bold. Driven by their local constituents, they will want to undo many of the deep education, human services, corrections, public safety, and infrastructure cuts that the state made in the past decade, seeking targeted tax and fee increases to do so. But these impulses will run up against the governor's promise of no new taxes without popular ballot approval.

A New Scene

In sum, a new political scene is beginning in Sacramento. The governor wants a peripheral tunnel system to carry water through the Delta and a Bullet Train. Legislators in the north who are not concerned about their water supply, or who aren't situated along the bullet train route, will want something in return for their support. Everybody wants to reform the ways money flows from local governments to the state and back again. And local governments' wish-lists are endless.

If the state economy continues to improve, even slowly, much is likely to be accomplished, and Jerry Brown will likely be looking at running for re-election again in 2014 to complete his legacy. If, however, the state's economy performs poorly, public trust in government will decline. In that event, Jerry Brown will leave Sacramento under the same unpopular clouds that trailed modern Governors Pete Wilson, Gray Davis, Arnold Schwarzenegger, and, a long time ago, Jerry Brown.

Brown's Vision

But that's not the governor's plan. The governor was asked in an interview, "So what's the best scenario after your tenure – where are we in two or three years?" Brown answered, "We have balance, and people feel confidence in our fiscal management. We have our water plan launched, our cap-and-trade is working, our prison realignment is reducing recidivism at a lower cost, we've gotten some reform in our educational funding – being more successful particularly among low-income families. We are building our track for our high-speed rail. Our trade and ports are humming along, and the environmental leadership of California has been picked up by other states in the nation."[21]

Beyond that, in an earlier exchange in the interview, Brown seemed to reveal that an Act 3, for him and California, is just the prequel to another Act 1, with a whole new set of challenges.

> **Barring extreme weather, if the state becomes increasingly majority-minority, when it becomes browner – browner, with a small b – won't we see a political sea change?**
>
> Brown: It'll be browner because we'll be having forest fires.
>
> **Come on, you're more optimistic than that.**
>
> Brown: No. Ever read Jim E. Hansen? Climate change is serious stuff. Extreme events—they will happen. We'll cope with them. But there'll be more expenses. We're storing up a lot of liabilities that we'll have to deal with. Yes, there will be a different demographic balance, different environmental challenges, and there'll be a different economic picture. It's very hard to predict. I would say it's not going be any easier than it is today. It will probably be harder.
>
> **Something to look forward to.**
>
> Brown: I'm looking forward to it.
>
> **Why's that?**
>
> Brown: I enjoy this type of work.[22]

Endnotes

[1] Quoted in David Siders, "Jerry Brown plans to restrain Democratic desires at the Capitol," *Sacramento Bee,* November 9. 2012.
[2] Quoted in Aaron Sankin, "Jerry Brown: 'I Just Want To Get Sh*t Done,'" *Huffington Post*, July 27, 2012 –updated September 4, 2012.
[3] Prop 187 of 1994 sought to deprive illegal immigrants in California of public services. It was largely voided through litigation.
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[5] "Republican Voters Shrink to 29% in the State." *Los Angeles Times Blogs,* November 3, 2012
[6] "Half of likely Voters Favor Proposition 30 – Support Slightly Lower for Proposition 38." Survey by the Public Policy Institute of California, September 19, 2012
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[8] Chip Johnson, "Jerry Brown is a mayor, not Governor Moonbeam," *SFGate blog*, March 19, 2010.
[9] David Siders, "The Buzz: Jerry Brown likens his budget to a classic play," *Sacramento Bee,* May 23, 2012.
[10] Marc Cooper, "The Governor's last stand," *Pacific Standard*, August 16, 2012. http://www.psmag.com/politics/the-governors-last-stand-44798/
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[13] Darrell Steinberg, website video http://sd06.senate.ca.gov/.
[14] Michael J. Michak, "Assembly speaker downplays new powers, vows no new taxes," *Los Angeles Times* November 7, 2012**.**
[15] California High Speed Rail Authority, "California 2012 Revised Business Plan Worksheet" http://www.cahighspeedrail.ca.gov/assets/0/152/302/e4542793-c05d-4737-a214-e1d1074b37eb.pdf.
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[18] Aaron Sankin, *Ibid*.
[19] George Skelton, "Gov. Brown gets a big win, but also a big responsibility," *Los Angeles Times*, November 7, 2012.
[20] John Wildermuth, "Fairness is key to split roll tax fight," *Fox and Hounds* blog. April 6, 2012.
[21] Cooper, *Ibid.*
[22] Cooper, *Ibid.*